



National Association of
Professional Surplus Lines
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March 10, 2014

Chairman Megna
Chairman Crisco

RE: House Bill 5366-OPPOSE

Dear Committee Members:

On behalf of the National Association of Professional Surplus Lines Offices (NAPSLO), we appreciate the opportunity to submit testimony to today's hearing on HB 5366. NAPSLO is the national trade association representing the surplus lines industry and the wholesale insurance distribution system. Since its founding in 1974, NAPSLO has become the authoritative voice of the surplus lines industry, advocating for the industry's vital role in the insurance marketplace and global economy. The surplus lines market plays an important role in providing insurance for hard-to-place, unique or high capacity (i.e., high limit) risks. Often called the "safety valve" of the insurance industry, surplus lines insurers fill the need for coverage in the marketplace by insuring those risks that are declined by the standard underwriting and pricing processes of admitted insurance carriers. With the ability to accommodate a wide variety of risks, the surplus lines market acts as an effective supplement to the admitted market.

Surplus lines insurers are able to cover unique and hard-to-place risks because, as nonadmitted insurers, they are able to react to market changes and accommodate the unique needs of insureds that are unable to obtain coverage from admitted carriers. This results in cost-effective solutions for consumers that are not "one size fits all," but are instead skillfully tailored to meet specific needs for non-standard risks.

NAPSLO's membership consists of approximately 400 brokerage member firms, 100 company member firms and 200 associate member firms, all of whom operate over 1,500 offices representing approximately 15,000 to 20,000 individual brokers, insurance company professionals, underwriters and other insurance professionals in the 50 states and the District of Columbia. NAPSLO is unique in that both surplus lines brokers and surplus lines companies are full members of the association; thus NAPSLO represents and speaks for the surplus lines wholesale marketplace.

NAPSLO is concerned with the proposed legislation in HB 5366. We have reviewed the comments and strongly support the testimony submitted by the New England Surplus Lines Association (NESLA) and the Property and Casualty Insurers Association of America (PCI).

We believe it is critical to have a full understanding of the differences between the admitted and non-admitted markets before moving forward with any changes to the existing legislation. The nonadmitted market exists to provide coverage when the admitted market is unwilling or unable to provide it. The nonadmitted insurance market's role as a "safety valve" for the insurance industry is critical to providing consumer solutions. Any prohibition, interruption or limitation of nonadmitted industry's ability to provide insurance will significantly reduce the insurance options for the insured.

Surplus lines insurers are able to cover unique and hard-to-place risks because, as nonadmitted insurers, they are able to react to market changes and accommodate the unique needs of insureds that are unable to obtain coverage from admitted carriers. The standard rating analysis does not apply to these risks because the risk profiles, catastrophe exposure, coverage limits and/or values may differ substantially from those the admitted market can rate and place. Because of these differences, it is important to analyze such attributes when analyzing the related pricing of the coverage. Therefore, requiring specific provisions in the policy, such as replacement cost, is not in-line with the individual analysis utilized by the nonadmitted market.

Further, as part of the regulatory process, nonadmitted insurers enjoy the "freedom from rate and form." Freedom from regulation of rates and forms is what distinguishes the surplus lines market from the admitted market and is the essential feature that allows the surplus lines industry to serve the consumer and function as a market for hard to place risks. The result of the freedom from rate and form are cost-effective solutions for consumers that are not "one size fits all," but are instead skillfully tailored to meet specific needs for non-standard risks with the flexibility to react to market changes and accommodate the unique needs of insureds that are unable to obtain coverage from admitted carriers. Requiring the nonadmitted market to use standard forms hampers the ability of the nonadmitted insurer to provide the unique risk, already rejected by the standard market, the most cost-effective and efficient coverage.

We have attached a copy of A.M. Best's 2013 Special Report reviewing the U.S. Surplus Lines Market. We believe this report demonstrates the strength of the surplus lines industry and will be of interest to the Committee as you review the proposed legislation.

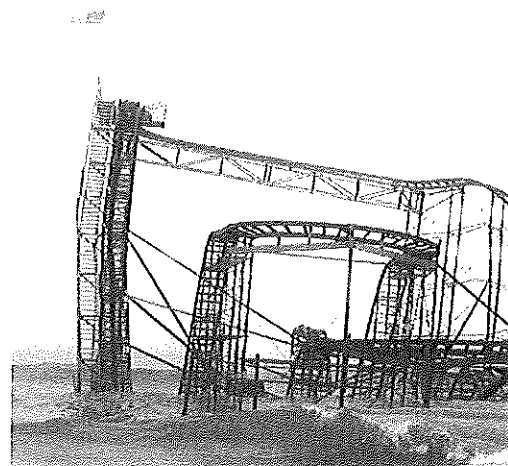
Thank you for your consideration of our comments, as well as our colleagues at the NESLA and PCI.

Sincerely,

Keri A. Kish
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BEST'S SPECIAL REPORT

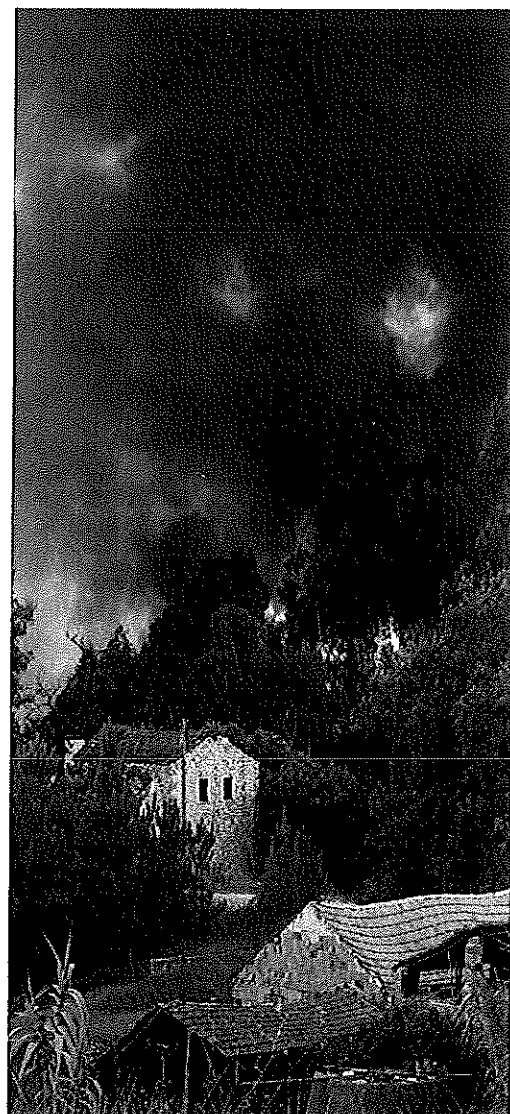
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U.S. Surplus Lines – Segment Review Thriving Through Turmoil

September 2013

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One Hundred Twenty-Two (122)

Effective as of December 20, 1988

11th

March

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Audrey Bauman Treasurer XXXXXXXX

Charlene Girden

Segment Review
September 23, 2013

2012 reversed
surplus lines'
usual out-
performance
of the P/C
industry.

Surplus Lines Results Stumble Amid Sandy Losses, but Premium Growth Continues

Overview

Surplus lines insurers in 2012 posted one of their worst years overall in recent memory, as the underwriting performance of U.S. domestic professional and domestic specialty surplus lines companies fell below that of the total property/casualty (P/C) industry for the first time in a more than a decade. Much of the blame for these results falls to Superstorm Sandy, which pummeled New York and New Jersey on Oct. 29, 2012, wreaking havoc on coastal properties, businesses and infrastructure all along the Northeastern seaboard.

The latest estimates place insured losses from Sandy near \$25 billion. While it's unclear how much of this insured loss the surplus lines market will absorb, these insurers' fourth-quarter loss ratio surged nearly 12 points, to 64.8 from 52.9, indicating that surplus lines were not spared. A.M. Best's domestic professional surplus lines (DPSL) peer composite experienced a downturn in profitability in 2012, causing pretax operating income to decline 24.3% and net income to drop 10.2%. Net income, however, was still sizable at \$1.57 billion, compared with \$1.75 billion in 2011.

Through 2011, the DPSL composite's results clearly outpaced those of the total P/C industry (including the mortgage and financial guaranty market segment), as reflected in the composite's 100.3 and 92.9 five- and 10-year combined ratios compared with 103.9 and 100.8, respectively, for the P/C industry. In 2012, however, a reversal of fortune occurred, as the P/C industry saw its pretax and net income increase by 119.2% and 85.0% respectively, while the DPSL composite's results declined.

Maintaining the momentum from 2011, the composite reported increased growth in direct premium written (DPW) at 6.8% in 2012, compared with 3.1%, in 2011. This compares with 4.4% year-over-year growth for the P/C industry. Growth in 2011 marked the first year since 2006 that the DPSL composite's premium grew.

A.M. Best believes that given the recent overall uptick in rates, as well as the relative lack of natural catastrophe-related losses recorded in the first half of 2013, the surplus lines market is on track to produce an underwriting profit in 2013. However, the lingering effects of Sandy and the sustained low interest rate environment still present challenges to the industry.

Also included in this report are results from A.M. Best's survey of surplus lines insurers, which gauge the relative shares of premium running through various types of intermediaries, and how widely used each type of distributor is.

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Section I – State of the Market

No storm in recent memory has had such a devastating impact on the Eastern Seaboard as Superstorm Sandy. On Oct. 29, 2012, Sandy pummeled New York and New Jersey, wreaking havoc on coastal properties, businesses and infrastructure all along the Northeastern seaboard. In contrast to its swift force, the impact from Sandy lingered. Businesses and government agencies were unable to get up and running for weeks, and in some cases months, because of the extensive flooding and the widespread nature of this storm. Sandy is likely to be counted among the costliest natural disasters in U.S. history, and surplus lines insurers were no exception to the wrath that Sandy dispensed.

Through the third quarter of 2012, the surplus lines industry seemed to be on its way to an exceptional year. Price firming and lower than average weather-related losses were proving to be significant drivers, despite the continued headwinds from a gradual economic recovery, high unemployment and a low interest rate environment. Then, in late October, everything changed with Sandy's arrival.

The latest estimates place insured losses from Sandy near \$25 billion. While it's unclear how much of this insured loss will be absorbed by the excess and surplus lines market, these insurers' fourth-quarter loss ratio surged nearly 12 points, to 64.8 from 52.9, indicating that surplus lines were not spared. As for loss ratios in New York and New Jersey, the two states that took the brunt of Sandy, these ratios ballooned upward of 130 versus 48 and 63 posted in the third quarter (respectively). In the fourth quarter alone, net

Exhibit 1

U.S. Surplus Lines – Direct Premiums Written (DPW) by Segment (1988-2012)

(\$ Millions)

Year	TOTAL P/C INDUSTRY		TOTAL SURPLUS LINES		DOMESTIC PROFESSIONALS				LLOYD'S			
	DPW	Annual % Chg	DPW	Annual % Chg	DPW	Annual % Chg	SL Market Share	No. of Cos.	DPW*	Annual % Chg	SL Market Share	
1988	211,270	4.2%	6,281	-4.3%	3,704	-10.4%	59.0%	86	1,237	-7.5%	19.7%	
1989	220,620	4.4%	6,123	-2.5%	3,530	-4.7%	57.7%	88	1,182	-4.4%	19.3%	
1990	230,757	4.6%	6,532	6.7%	3,882	10.0%	59.4%	117	1,241	5.0%	19.0%	
1991	235,627	2.1%	6,924	6.0%	4,081	5.1%	58.9%	117	1,322	6.5%	19.1%	
1992	240,410	2.0%	7,549	9.0%	4,491	10.0%	59.5%	120	1,388	5.0%	18.4%	
1993	253,847	5.6%	8,540	13.1%	5,270	17.3%	61.7%	123	1,631	17.5%	19.1%	
1994	263,653	3.9%	8,786	2.9%	6,089	15.5%	69.3%	115	1,196	-26.7%	13.6%	
1995	273,929	3.9%	9,245	5.2%	6,511	6.9%	70.4%	112	1,300	8.7%	14.1%	
1996	279,990	2.2%	9,205	-0.4%	6,668	2.4%	72.4%	108	1,354	4.2%	14.7%	
1997	287,196	2.6%	9,419	2.3%	6,569	-1.5%	69.7%	106	1,609	18.8%	17.1%	
1998	300,309	4.6%	9,861	4.7%	6,763	3.0%	68.6%	107	1,574	-2.2%	16.0%	
1999	308,671	2.8%	10,615	7.6%	7,265	7.4%	68.4%	105	1,912	21.5%	18.0%	
2000	327,286	6.0%	11,656	9.8%	7,884	8.5%	67.6%	98	2,499	30.7%	21.4%	
2001	367,798	12.4%	15,813	35.7%	10,773	36.6%	68.1%	104	3,368	34.8%	21.3%	
2002	422,703	14.9%	25,565	61.7%	19,572	81.7%	76.6%	108	4,082	21.2%	16.0%	
2003	463,033	9.5%	32,799	28.3%	25,662	31.1%	78.2%	115	4,492	10.0%	13.7%	
2004	481,588	4.0%	33,012	0.6%	25,744	0.3%	78.0%	115	4,596	2.3%	13.9%	
2005	491,429	2.0%	33,301	0.8%	25,968	0.9%	78.0%	111	4,675	1.7%	14.0%	
2006	503,894	2.5%	38,698	16.3%	29,410	13.3%	76.0%	117	5,989	28.1%	15.5%	
2007	506,180	0.5%	36,637	-3.5%	27,675	-5.9%	74.1%	120	6,360	6.2%	17.0%	
2008	492,881	-2.6%	34,365	-6.2%	24,612	-11.1%	71.6%	130	6,062	-4.7%	17.6%	
2009	481,410	-2.3%	32,952	-4.1%	22,830	-7.2%	69.3%	139	6,090	0.5%	18.5%	
2010	481,120	-0.1%	31,716	-3.8%	21,882	-4.2%	69.0%	143	5,789	-4.9%	18.3%	
2011	501,555	4.2%	31,140	-1.8%	22,582	3.2%	72.5%	146	5,790	0.0%	18.6%	
2012	523,360	4.3%	34,808	11.8%	25,490	12.9%	73.2%	142	6,270	8.3%	18.0%	

* Estimates

Source: A.M. Best data & research, 

underwriting losses exceeded \$1 billion. This also takes into consideration \$170 million of favorable prior-year reserve development in the quarter, which puts the pretax price tag for Sandy at approximately \$1.2 billion.

Overall, 2012 was among the worst years in recent memory for surplus lines insurers, as the underwriting performance of U.S. surplus lines companies – domestic professional ¹ and domestic specialty ² – fell below that of the total property/casualty (P/C) industry for the first time in a more than a decade.

Aside from 2012, surplus lines companies have been extremely successful when compared with the property/casualty industry. The most recent five- and 10-year periods exemplify this disparity, which A.M. Best believes is due to surplus lines insurers' freedom of rate and form, customization, innovation and ability to adapt quickly to insureds' needs as they arise. Since surplus lines companies typically underwrite coverage for tougher risks that are hard to place in the admitted marketplace, there is a greater focus on tighter underwriting that correlates to the nature of the risk exposures being covered.

In this update on the state of the market, A.M. Best will focus on, among other things:

- Growth of market share among surplus lines insurers.
- Key drivers of premium growth.

¹ Domestic professional surplus lines companies are U.S.-domiciled insurers that write 50% or more of their total direct premium written on a nonadmitted basis.

² Domestic specialty companies are U.S.-domiciled insurers that operate to some extent on a nonadmitted basis but whose direct nonadmitted premium writings amount to less than 50% of their total direct premium written.

REGULATED ALIENS (excluding Lloyd's)					DOMESTIC SPECIALTY				
DPW	Annual % Chg	SL Market Share	No. of Cos.		DPW	Annual % Chg	SL Market Share	No. of Cos.	
1,012	31.3%	16.1%	104		328	2.2%	5.2%	128	
1,050	3.8%	17.1%	101		361	10.1%	5.9%	123	
1,013	-3.5%	15.5%	85		396	9.7%	6.1%	149	
1,111	9.7%	16.0%	85		410	3.5%	5.9%	151	
1,220	9.8%	16.2%	74		450	9.8%	6.0%	151	
1,183	-3.0%	13.9%	70		456	1.3%	5.3%	138	
992	-16.1%	11.3%	64		509	11.6%	5.8%	141	
1,022	3.0%	11.1%	57		412	-19.1%	4.5%	144	
818	-20.0%	8.9%	57		365	-11.4%	4.0%	125	
802	-2.0%	8.5%	59		439	20.2%	4.7%	114	
1,196	49.1%	12.1%	58		328	-25.3%	3.3%	113	
1,140	-4.7%	10.7%	55		298	-9.1%	2.8%	116	
941	-17.5%	8.1%	46		332	11.4%	2.8%	106	
1,362	44.7%	8.6%	44		310	-6.6%	2.0%	91	
1,600	17.5%	6.3%	46		311	0.3%	1.2%	76	
2,400	50.0%	7.3%	45		245	-21.2%	0.7%	63	
2,400	0.0%	7.3%	53		272	11.0%	0.8%	59	
2,400	0.0%	7.2%	50		238	-12.5%	0.7%	57	
3,100	29.2%	8.0%	55		199	-16.4%	0.5%	54	
3,100	0.0%	8.3%	55		202	1.5%	0.5%	56	
3,403	9.8%	9.9%	53		288	42.6%	0.8%	70	
3,735	9.8%	11.3%	55		297	3.1%	0.9%	69	
3,758	0.6%	11.8%	56		287	-3.4%	0.9%	66	
2,537	-32.5%	8.1%	53		231	-19.5%	0.7%	60	
2,747	8.3%	7.9%	61		301	30.3%	0.9%	53	

- Mergers and acquisitions among surplus lines and specialty lines insurers.
- Performance among the leading surplus lines groups.
- A.M. Best's views on the near-term market cycle.

Many of the large, standard market insurers historically have dominated commercial lines premium and continue to do so. However, A.M. Best finds that surplus lines insurers have made inroads, now accounting for approximately 13.4% of all commercial lines direct premiums written, up from 11.1% a decade earlier and equal to the share recorded five years ago. A.M. Best believes this trend is likely to continue, as more borderline surplus lines business will be shifted into the surplus lines sector amid improving market conditions and changing risk appetites for standard market insurers.

Although it is very difficult to predict insurers' behavior, A.M. Best believes standard market insurers remain steadfast in their desire to retain business. However, considering the prevailing low interest rate environment and tighter profit margins, they may be less aggressive in retaining some of this "fringe" business. As a result, some additional business may find its way back into the surplus lines market.

Aside from the ebbs and flows of the business, both the admitted and nonadmitted sectors continue to benefit from ongoing improvements in the overall economy in 2012 and 2013; the recent trend of rate increases; and the relative lack of catastrophic events in 2012 with one major exception – Sandy. Combined, these factors have helped the overall results of both sectors and led to year-over-year growth in the premiums produced by 22 of the top 25 surplus lines groups in 2012. In addition, the overall, aggregate performance of the surplus lines companies continues to outpace that of the total P/C industry (see **Section II: Financial Condition and Rating Distribution**). (For the surplus lines industry's direct premium results, see **Exhibit 1**).

In 2012, groups whose primary focus is surplus lines/specialty business, particularly market leaders, once again generated considerable operating profits and returns on both revenue and, to a smaller degree, surplus (see **Exhibit 2**). In 2012, reserves of the specified surplus lines specialists developed favorably by 3.0%, compared with 2.1%

Exhibit 2 Surplus Lines Specialists* – Operating Performance (2012)

(%)

Group Name	Change In DPW	Loss/LAE Ratio	Combined Ratio	Pre-Tax ROR	Pre-Tax ROE
W.R. Berkley Group	12.2	63.7	96.4	14.4	12.9
Markel Corporation Group	11.1	58.1	100.0	8.7	8.1
Alleghany Insurance Holdings	13.1	70.8	103.9	11.1	8.0
Argonaut Group	4.9	69.9	107.1	12.9	7.2
RLI Group	9.3	47.2	88.0	23.8	19.7
Global Indemnity Group	-11.8	75.6	115.8	5.9	1.2
HCC Insurance Group	1.2	51.6	84.5	42.4	20.8
IFG Companies	22.9	53.9	91.9	14.9	6.9
James River Insurance Co	21.0	61.5	85.6	56.1	10.9
Western World Insurance Group	18.7	70.0	104.5	10.9	5.6
AXIS Insurance Group	5.9	72.0	109.8	1.5	0.8
Arch Insurance Group	8.7	75.2	108.4	-5.2	-5.5
Catlin U.S. Pool	19.7	71.3	94.8	7.1	3.7
Average - Surplus Lines Specialists	10.5	64.7	99.3	15.7	7.7
Total P/C Industry	4.4	74.3	103.1	7.7	6.0

* U.S.-domiciled insurers that primarily write surplus lines and/or specialty admitted business.
Source: **BEST** – A.M.B. Credit Report - Insurance Professional

of favorable development for the total P/C industry (see **Exhibit 3**). A.M. Best believes, however, that from an overall market perspective, early loss-reserve takedowns will continue to compromise balance sheets. A.M. Best also believes that in time, insurers no longer will have the ability to release prior-year loss reserves, which insurers have used in recent years to help offset weakness in more current results. While A.M. Best believes loss reserves already may be deficient, it also expects commercial insurers to continue posting reserve redundancies in 2013; however, beyond 2013, the ability

to release reserves will be nearing its end. Many of the surplus lines specialists, however, have a proven history of conservative reserving and effective cycle management that has led to considerable balance sheet strength over the long term. These entities' ability to continue benefitting from reserve redundancies could last longer than is predicted for commercial lines insurers overall.

Given the magnitude of losses associated with Sandy, surplus lines insurers posted higher than anticipated loss and combined ratios in 2012 – in fact, higher than those of the P/C industry. By most key measures of operating performance, the margin between the surplus lines and P/C industries narrowed in 2012, but it remains significant when measured by returns on revenue. In addition, elevated loss ratios in general liability and professional liability were worse than in 2011 because of less reserve redundancies in 2012.

Also noteworthy is the year-over-year disparity in top-line growth for the surplus lines industry compared with the P/C Industry. In 2012, direct premiums written (DPW) for surplus lines increased 11.8%. This compares with an annualized DPW growth rate for the total P/C Industry of 4.3% (see **Exhibit 1**). This growth reflects rate increases insurers took on many lines of business, as well as the impact of some business moving from the standard lines market back into the nonadmitted or surplus lines market, as discussed previously.

Even more pronounced was the momentum of the core domestic professional surplus lines insurers, which showed DPW advancing 12.9% in addition to the 3.2% growth reported in 2011. The total increase in DPW for the surplus lines industry also was due to an 8.3% increase for Lloyd's; a 10.9% increase for non-Lloyd's alien (non-U.S.) companies whose premium is tracked by the National Association of Insurance Commissioners (NAIC); and a noteworthy 30.3% increase for domestic specialty insurers. This increase underscores insurers' growing interest in the surplus lines market, including insurers that write some surplus lines business but may concentrate more on the specialty admitted or standard markets. The domestic specialty companies' growth has come from both new products and growth of existing, smaller books of business into larger portfolios. The increase in total surplus lines premium reversed five consecutive years of decline, which had been unprecedented over the past two decades (see **Exhibits 4, 5 and 6**).

Over the past 20 years, the surplus lines market has expanded substantially, increasing DPW by more than four and one-half times over that period (see **Exhibit 6**). Growth of the surplus lines market, as a percentage of total commercial lines premium, also has increased steadily during the past two decades; however, the bulk of commercial lines business still is written on an admitted basis. The commercial lines segment consistently has accounted for 75%-80% of all surplus lines business written.

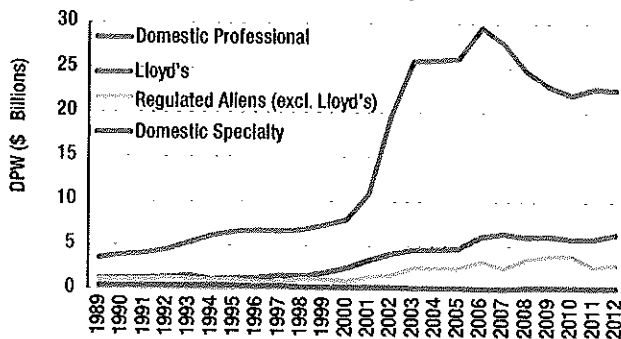
Exhibit 3 Top Surplus Lines Specialists – Loss Reserve Development (2012 Calendar Year)

(\$ Thousands)

Group Name	1-Year Loss-Reserve Development Through 2012	1-Year Development to Original 2011 Reserves (%)
W.R. Berkley Group	-\$69,944	-0.9
Markel Corporation Group	-209,401	-8.3
Alleghany Insurance Holdings	-25,970	-0.3
Argo Group	-5,655	-0.5
RLI Group	-71,095	-9.5
Global Indemnity Group	-7,004	-2.5
HCC Insurance Holdings	-51,834	-2.8
IFG Companies	-29,161	-7.2
James River Insurance Co	-7,655	-6.0
Western World Insurance Group	-13,075	-2.3
AXIS Surplus Insurance Co	-64,134	-4.2
Arch Insurance Group	-26,527	-2.8
Catlin U.S. Pool	7,649	8.6
Average - Surplus Lines Specialists	-44,139	-3.0
Total P/C Industry	-\$13,008,000	-2.1

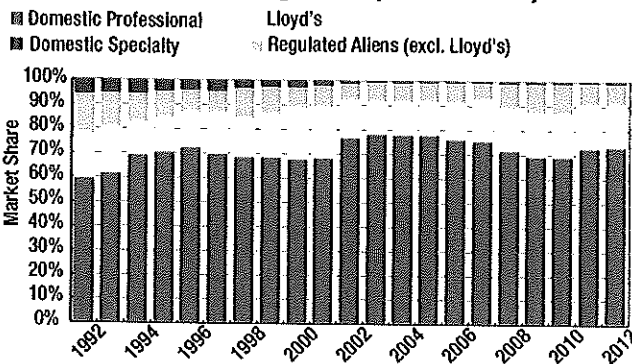
Source: A.M. Best data & research

Exhibit 4
U.S. Surplus Lines –
DPW by Segment (1989-2012)



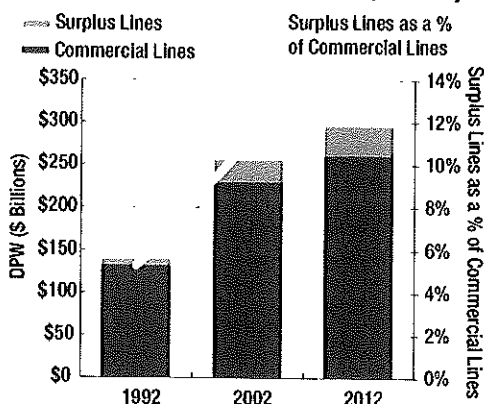
Source: A.M. Best data & research

Exhibit 5
U.S. Surplus Lines –
Market Share by Segment (1992-2012)



Source: A.M. Best data & research

Exhibit 6
U.S. Surplus Lines vs. Commercial
Lines – DPW* (1992, 2002, 2012)



* Direct premiums written
 Source: A.M. Best data & research

Through the first quarter of 2013, total DPW and net premiums written (NPW) increased for both personal and commercial lines. This reflects strong pricing trends in personal lines, particularly on homeowners and, to a lesser extent, private passenger automobile. A slowly improving economic environment is expanding exposure bases, and ongoing rate firming, particularly on the workers' compensation line, is helping to drive premium upward for the commercial lines segment. However, while economic conditions have improved slowly, additional recovery is needed, and with the significant market capacity available, the return to a full hard market is unlikely in the near term.

In recent years, weak economic conditions – specifically reflected in the absence of notable start-ups, decreasing sales and declining payrolls – have depressed growth in the surplus lines sector. A major source of pressure on pricing and compressed profit margins for surplus lines insurers traditionally has been competition from standard market insurers for moderate and higher hazard risks traditionally insured in the surplus lines market.

Growth Trends and the Cycle

The surplus lines industry's growth and contraction largely tracks with the overall insurance market cycle. When market conditions harden, standard market carriers tend to turn away from more traditional surplus lines risks to refocus on their core business. Low yields on new money, along with persistent competition for borderline and traditional surplus lines accounts from well-capitalized insurers, also have challenged surplus lines insurers for a number of years.

Despite the recent 100-basis-point increase in 10-year Treasuries, A.M. Best believes interest rates are likely to remain low in the intermediate future, which will continue to put pressure on investment

returns. As a result, A.M. Best believes this low interest rate environment should continue to foster improved pricing and focus on underwriting fundamentals, which could further accelerate the shift of business into the surplus lines segment in 2013.

Stamping Offices Report Growth in Surplus Lines Premium

According to information compiled by the Surplus Lines Stamping Office of Texas, the 14 states maintaining stamping offices reported a 0.9% increase in premium volume in 2012. However, the overall growth in premium was disproportionately constricted by the large amount of prior years' return premium transactions processed in New York.

Adjusted for this anomaly, the 13 other offices (excluding New York) reflected a \$1.8 billion or 11.8% increase in premium. Interestingly, the stamping offices reported a 2.7% decline in the number of documents filed: 3.05 million in 2012, compared with 3.13 million in 2011. The document count indicates the number of policies and endorsements handled by the various stamping offices.

A change in document count provides a rough estimate of the flow of business into and out of the surplus lines market. In this case, the decrease in the document count continues to reflect the level of competition for surplus lines business from standard market insurers.

The stamping offices only report on 14 states, and the results are influenced heavily by four states — California, Florida, New York and Texas. New York generated the fourth-highest premium volume of these states, after generating the second-highest premium in 2011. The state's 2012 results clearly show the effect of the aforementioned prior year's return premium items on its total production.

Through the first six months of 2013, the reported document count reveals an increase of 4.1%, compared with a decrease of 3.5% in 2011. The 21.2% increase in the six-month reported premium figure between 2013 and 2012 reflects sizable increases in the aforementioned four leading states, with the New York numbers again skewed by specific transactional anomalies. The premium change represents a drastic difference from the 9.8% decline in the six-month reported premium between 2012 and 2011.

The six-month premium for New York in 2013 was \$1.53 billion, compared with \$824.9 million in 2012. Excluding the premium reported for New York, the premium reported by the stamping offices in 2013 is up by almost 15.1% over 2012. After increasing by 8.3% during the first half of 2012, premium in California increased by 17.0% during the first six months of 2013.

Meanwhile, Texas has experienced an even larger, 23.8% increase, due in part to varied assessments by the Texas Department of Insurance for late filings. In 2012, Florida showed a decline in the number of items filed, but in 2013, the state processed 2.0% more items during the first half of the year, helping to generate a 10.2% increase in premium.

The fact that the increases in premium by state exceed the increase in the number of items processed is consistent with the prevailing trend toward firmer pricing in the surplus lines market, which A.M. Best believes will continue at least through the end of 2013.

Over the past few years, new entrants also have caused a slight increase in the number of both domestic professional surplus lines and domestic specialty companies. However, recent consolidations of companies and groups have somewhat constrained the increase in the number of domestic professional surplus lines carriers, as organizations interested in the market have tended to use acquisitions to achieve top-line growth of premium they otherwise could not attain, provided profitability is a primary objective.

The number of domestic specialty companies declined by approximately 40% from the beginning of 2001 through 2006, reflecting the retrenching of some admitted insurers during the hard market that occurred through much of that period. This allowed the remaining domestic specialty companies to write more business on a nonadmitted basis, some increasing that volume to more than 50% of their total portfolios.

An Ongoing Shift

The trend has continued, with the number of companies identified by A.M. Best as domestic specialty insurers decreasing to 60 from 70 between year-end 2007 and year-end 2011. As noted above, considerable merger and acquisition activity in the surplus lines market over the past decade has obscured some of these trends. However, the increase in the number of companies identified as domestic professionals is clear evidence of the increased interest in traditional surplus lines business, despite heavy market competition for this business over the past several years.

Pretax returns on revenue (net premiums earned) and surplus for the top group of surplus lines specialists again outpaced the returns of the P/C industry by a wide margin. These results reflect the benefits of the surplus lines market's freedom of rate and form, which have accrued despite a shrinking top-line volume of business written. Another key reason for the market's comparatively superior results is surplus lines underwriters' expertise in selecting, underwriting, pricing and servicing higher hazard classes of risk. The most effective servicing of surplus lines risks often entails use of loss-control and risk management services to add value for the policyholder in identifying key exposures to loss.

Leading Surplus Lines Companies and Groups

In 2012, Lloyd's maintained the status it has held for the past three years as the market-share leader, generating year-over-year growth in surplus lines premium of 8.3%. During the year, Lloyd's also surpassed its record for business sourced in the United States, exceeding \$6.0 billion of DPW. This comes only two years after Lloyd's overtook the once acclaimed domestic leader in surplus lines premium production, American International Group (AIG), in 2010. Key drivers of this shift in market share include Lloyd's ability to attract third-party investors' capital, and AIG's attempt to de-leverage and de-risk its balance sheet in the aftermath of the financial crisis. Through its flagship Lexington Insurance Co., AIG reported slightly more than \$5.0 billion of DPW in 2012. Combined, these two organizations accounted for approximately 32% of the total surplus lines market (see **Exhibits 7 and 8**), down slightly from their 2011 combined total of 35%. AIG was, in fact, the only insurer among the top 10 insurance groups to experience a decline (5.7%) in surplus lines DPW in 2012.

Despite the well-publicized problems AIG encountered in 2008, it remains a leading surplus lines insurer and has maintained its presence and reputation as a formidable competitor in the market. In 2012, AIG still produced more than three times the level of direct premiums generated by its closest U.S. competitor, Nationwide Group (Nationwide).

During 2012, the 25 leading surplus lines groups accounted for approximately 74.1% of total surplus lines DPW, compared with approximately 76% in 2011. By comparison, the top 10 groups accounted for 55% of total premium. While the top 10 U.S. surplus lines groups in 2012 (in terms of DPW, including Lloyd's at No. 1) remained unchanged from last year, there were several shifts in the rankings. Perhaps most pronounced among the top 10 was QBE North America Group (QBE), which moved up four rungs from 10th place in 2011 to sixth in 2012.

QBE's ranking among professional U.S. surplus lines groups has grown steadily over the past several years as the company acquired several specialty commercial insurers to grow in the United States. In 2012, QBE recorded an extraordinary 75.0% increase in DPW, driven by premium growth from its most recent acquisitions, including NAU Country Insurance Co., the U.S. operations of RenaissanceRe (RenRe) and \$1.2 billion of forced-placed insurance previously written by Balboa Insurance Group. The premium from those acquisitions then rolled over onto the paper of its lead surplus lines insurer, QBE Specialty Insurance Co. (Excluding Lloyd's, Alleghany Insurance Holdings remained the 10th largest U.S. group writing surplus lines business).

Other changes in rankings among the top 10 surplus lines groups were those that switched rankings, specifically Nationwide and Zurich Financial Services North America Group (Zurich) at Nos. 3 and 4 for 2012, and W.R. Berkley Group and ACE INA Group at Nos. 5 and 6. The 8.7% increase in total DPW for the top 25 surplus lines writers somewhat reflects the price firming occurring in the P/C market, particularly on certain business considered to be "tougher classes" and "hard to place," such as transportation and professional liability (errors and omissions coverage) risks, high-hazard general liability classes and, to some degree, commercial umbrella.

As expected, areas that were exposed to and affected by recent weather-related events such as Midwestern tornados and Superstorm Sandy also are seeing higher rates as well as tighter coverage terms and conditions. Surplus lines writers also are generating higher premiums from new product endorsements covering burgeoning exposures such as cyber liability. However, for the most part, only limited cyber risk coverage is being offered. In addition, many surplus lines insurers have reported lessening competitive pressure from standard market companies. Although another year of positive rate movement bodes well for domestic professional surplus lines, there are already early signs that commercial pricing may be moderating somewhat as the second half of 2013 unfolds.

In addition to the mainstays, 2012 marked the entrance of three new entities into the top 25: the California Earthquake Authority (CEA) at No. 13, Great American P&C Insurance Group at No. 23 (up from No. 28 in 2011) and Catlin U.S. Pool at No. 24 (up from No. 27 in 2011). The CEA is a unique entity in that it is privately

Exhibit 7
U.S. Surplus Lines – Top 25 Groups (2012)
Ranked by direct premiums written.
(\$ Thousands)

Rank	AMB No.	Group Name	Surplus Lines DPW	Total Surplus Lines Market Share (%)
1	85202	Lloyd's	\$6,270,000	18.0
2	18540	American International Group	5,041,769	14.5
3	05987	Nationwide Group	1,441,724	4.1
4	18549	Zurich Financial Svcs NA Group	1,176,246	3.4
5	18252	W.R. Berkley Group	1,116,267	3.2
6	18713	QBE North America Group	1,020,691	2.9
7	18498	ACE INA Group	887,402	2.5
8	18468	Markel Corporation Group	821,559	2.4
9	18313	CNA Insurance Cos	781,184	2.2
10	18728	Ironshore Insurance Group	674,192	1.9
11	18640	Alleghany Insurance Holdings	657,981	1.9
12	03116	Fairfax Financial (USA) Group	650,832	1.9
13	12534	California Earthquake Authority	566,664	1.6
14	18603	AXIS Insurance Group	476,044	1.4
15	18130	XL America Group	454,892	1.3
16	18484	Arch Insurance Group	448,167	1.3
17	18591	Allied World Group	426,524	1.2
18	00012	Chubb Group of Insurance Cos	426,451	1.2
19	04019	Argo Group	409,909	1.2
20	00811	Berkshire Hathaway	406,603	1.2
21	00060	Liberty Mutual Insurance Cos	355,104	1.0
22	18523	HCC Insurance Group	336,382	1.0
23	04835	Assurant P&C Group	319,307	1.4
24	18720	Great American P&C Group	314,626	1.3
25	00060	Catlin U.S. Pool	305,896	0.9
Subtotal of Top 25			\$25,786,416	74.1
Total U.S. Surplus Lines Market			\$34,808,000	100.0

Source: A.M. Best data & research

Exhibit 8

U.S. Surplus Lines – Top 25 Companies (2012)

Ranked by direct premiums written.

(\$ Thousands)

Rank	AMB No.	Company Name	Group Name	Surplus Lines DPW	Total Surplus Lines Market Share (%)
1	02350	Lexington Insurance Co	American International Group	\$4,231,392	12.2
2	03292	Scottsdale Insurance Co	Nationwide Group	1,270,469	3.6
3	03557	Steadfast Insurance Co	Zurich Financial Svcs NA Group	1,025,078	2.9
4	12562	QBE Specialty Insurance Co	QBE North America Group	1,020,691	2.9
5	03535	Chartis Specialty Insurance Co	American International Group	810,363	2.3
6	03538	Columbia Casualty Co	CNA Insurance Companies	740,808	2.1
7	13866	Ironshore Specialty Ins Co	Ironshore Insurance Group	665,592	1.9
8	12619	Landmark American Ins Co	Alleghany Insurance Holdings	589,564	1.7
9	12534	California Earthquake Authority	California Earthquake Authority	566,664	1.6
10	01990	Nautilus Insurance Co	W. R. Berkley Insurance Group	487,032	1.4
11	12515	AXIS Surplus Insurance Co	AXIS Insurance Group	476,044	1.4
12	11340	Indian Harbor Insurance Co	XL America Group	454,126	1.3
13	04433	Westchester Surplus Lines Ins	ACE INA Group	452,262	1.3
14	12523	Arch Specialty Insurance Co	Arch Insurance Group	448,167	1.3
15	03510	Illinois Union Insurance Co	ACE INA Group	422,328	1.2
16	03759	Evanston Insurance Co	Markel Corporation Group	409,242	1.2
17	03283	Colony Insurance Co	Argo Group	404,675	1.2
18	11883	First Mercury Insurance Co	Fairfax Financial USA Group	376,250	1.1
19	02732	Essex Insurance Co	Markel Corporation Group	371,637	1.1
20	02713	Chubb Custom Insurance Co	Chubb Group of Insurance Cos.	361,809	1.0
21	12078	Liberty Surplus Ins Corp	Liberty Mutual Insurance Cos.	355,104	1.0
22	03286	Houston Casualty Co	HCC Insurance Group	320,593	0.9
23	03026	Admiral Insurance Co	W.R. Berkley Insurance Group	311,669	0.9
24	10092	Catlin Specialty Insurance Co	Catlin U.S. pool	305,896	0.9
25	12118	Gemini Insurance Co	W.R. Berkley Insurance Group	280,144	0.8
Subtotal				\$17,157,599	49.3
Total U.S. Surplus Lines Market				\$34,808,000	100.0

Source: A.M. Best data & research

funded but publicly managed, providing earthquake insurance to California residents. Organic growth and higher average rates drove Great American's increase in DPW. Catlin U.S. Pool's ascension into the top 25 was driven by its ultimate parent organization's large investment during the pool's start-up phase over the past six years, as well as the continued introduction of new products.

As noted earlier, 22 of the top 25 surplus lines groups reported very healthy growth of premium. A.M. Best believes this high relative level of participation is a strong sign that the surplus lines market is turning. The following surplus lines groups experienced growth greater than 10%: Nationwide (14.9%), Zurich (10.8%), W. R. Berkley (14.2%), QBE North America (75.0%), Alleghany Insurance Holdings (13.8%), Fairfax Financial (18.5%), XL America Group (30.0%), Allied World Group (11.5%), Liberty Mutual (28.1%), Great American P&C (30.4%) and Catlin U.S. Pool (17.0%).

By DPW, seven of the top eight surplus lines groups (including Lloyd's) for 2012 were also among the 10 leading groups a decade earlier, for the 2002 calendar year (see Exhibit 9). Top U.S. groups that have been able to increase their market share over the past decade include Nationwide (4.1% market share from 3.4%), W.R. Berkley Group (3.2% from 2.2%) and Arch Insurance Group (Arch) (1.3% from 0.8%). QBE North America Insurance Group (2.9% market share in 2012) has increased its footprint in the U.S. specialty lines market through various acquisitions, while enhancing its profile within the surplus lines market. Also joining the top 15 surplus lines groups in the past decade were Alleghany Insurance Group (Alleghany), AXIS Insurance Group (AXIS) and

XL America Group (XL Group). The latter two are among a group of organizations that have Bermuda-based parents and have successfully entered and carved out niches in the very competitive surplus lines market.

While the top surplus lines groups historically have produced the majority of the market's DPW, the landscape has become more diverse, with a growing number of organizations and companies dedicating resources to surplus lines business. For 2002, the top 25 groups held 86.9% of the surplus lines market (see **Exhibit 9**), a full 13 percentage points greater than the 74.1% share held by the top 25 groups in 2012 – which was down a few points from 76.1% in 2011. The leading 25 groups' growth in DPW market share is tied to the continued growth achieved by some groups through acquisition. For example, Fairfax Financial USA Group (Fairfax) acquired First Mercury Group in 2011 and announced the acquisition of American Safety Insurance Holdings during the second quarter of 2013. Allied World meanwhile has increased its market share since acquiring surplus lines and specialty admitted writer Darwin Group in 2008.

Additionally, some of the groups that have emerged over the past several years, and continue to grow in prominence relative to top-line growth, have been those with well-capitalized, Bermuda-based parents such as Ironshore, AXIS and Arch. Some of these newer surplus lines groups and insurers have driven competition in the surplus lines market over the past nine years, while other nontraditional providers of surplus lines coverage also have expanded their focus toward specialty business after the end of the last hard market several years ago.

Despite changes in names and/or ownership, 14 of the top 25 groups/carriers have remained the same. Typically, changes in the top 25 over the past decade have resulted from market consolidations and new company formations, either by way of Bermuda-based parents or Lloyd's. Several large insolvencies or strategic changes at the corporate level caused other shifts.

A.M. Best believes the surplus lines market leaders have become dominant in certain segments because of their robust market profiles, some of which continue to be enhanced through acquisitions, in addition to their mature books of business. Moreover, these organizations have maintained disciplined pricing and underwriting despite the challenges associated with soft market conditions. In addition, diverse, strong and well-established distribution platforms have played a key strategic role in these groups' ability to attain consistently excellent results year after year.

The surplus lines market's growth and expansion over the long term sparked

Exhibit 9 U.S. Surplus Lines – Top 25 Groups (2002)

Ranked by direct premiums written.

(\$ Thousands)

Rank	Company Name	DPW	Total Surplus Lines Market
			Share (%)
1	American International Group	\$6,036,868	18.2
2	Lloyd's	4,082,000	12.7
3	Zurich/Farmers	1,282,026	5.2
4	Markel Corporation	1,197,867	3.5
5	Nationwide Group	984,534	3.4
6	Berkshire Hathaway	973,908	3.3
7	ACE INA	801,896	2.8
8	Royal & SunAlliance	698,572	2.3
9	W. R. Berkley	660,304	2.2
10	Travelers P&C Group	658,655	2.2
11	United National Group	514,573	2.1
12	Chubb Group of Insurance Cos	469,406	1.9
13	Hartford Insurance Group	447,262	1.8
14	Great American P&C	439,725	1.6
15	CNA Insurance Cos	428,742	1.4
16	St. Paul Companies	391,487	1.3
17	HDI U.S. Group	325,317	1.3
18	GE Global Insurance Group	305,028	1.2
19	RLI Group	283,695	1.2
20	Argonaut Insurance Group	243,401	1.1
21	Kemper Insurance Cos	215,264	1.0
22	Arch Capital Group	213,641	0.8
23	IFG Cos	210,265	0.8
24	Western World Insurance Group	184,216	0.8
25	HCC Insurance Group	160,766	0.7
Subtotal		\$22,209,418	86.9
Total U.S. Surplus Lines Market		\$25,564,502	100.0

Source: A.M. Best Co. Report *Annual Review of the Excess & Surplus Lines Industry*, September 2003.

investors' interest in the years after the last hard market, as evidenced by the formation of surplus lines start-up operations such as Arch and AXIS. Both of these groups were members of well-capitalized, Bermuda-based parent companies that owned other insurance and/or reinsurance operations. They both benefited greatly from the timing of the formation of their lead surplus lines companies – Arch Specialty Insurance Co. and AXIS Surplus Insurance Co. – at the onset of the hard market. These market opportunities also have enabled Bermuda organizations to diversify away from the catastrophe business of their other companies and into other classes at increased rate levels.

The Bermuda start-ups that commenced operations in 2005, such as Ironshore (the No. 10 surplus lines insurance group by DPW in 2012), Alterra (now part of Markel Corp.) (No. 30), and Endurance Specialty Group (No. 32), since have established domestic operations in the surplus lines and specialty markets. The 2005 insurers brought a great deal of capacity to the marketplace. As market conditions turned more competitive, thereby shrinking available profit margins, it has been more challenging for them to find appropriate opportunities to deploy available capacity.

A.M. Best believes newer surplus lines organizations will continue to face a significant challenge to settle into a more stable, maturing position in the market with successful long-term prospects, especially considering the still recovering economy; only gradual firming of prices noted to date; persistent competitive market conditions on some lines; excess capacity; and the increasing severity and frequency of recent catastrophe-related losses. Despite the ample capacity, there have been fewer opportunities for it to be used on business that produces the desired profit margins. Since cedants have been purchasing less reinsurance, it has been important for Bermuda organizations with affiliated reinsurers that also write direct surplus lines business to develop additional opportunities to deploy their capital.

The Lloyd's Market

Lloyd's has been active in the United States since the late 1800s and plays an extremely important role in the surplus lines market, as the top writer of nonadmitted business from 2010 through 2012. The United States continues to be Lloyd's biggest market, with surplus lines and reinsurance activities generating the majority of Lloyd's U.S. revenues. Lloyd's underwrites extremely varied risks, encompassing both property and liability loss exposures. With almost \$6.3 billion in DPW in 2012, Lloyd's represents approximately 18% of the surplus lines market.

Over the past decade, Lloyd's surplus lines premium volume has increased because of several factors, including increased marketing activity and the enhanced awareness of Lloyd's security ratings among buyers and producers. However, Lloyd's now is using a measured approach to pursuing business during this less favorable operating environment, which is causing written premiums to level off. Overall, A.M. Best believes Lloyd's will maintain its substantial participation in the U.S. surplus lines market, despite the volatile earnings inherent in surplus lines business.

Key Challenges Facing the Industry

In accordance with the state of the insurance industry as a whole, surplus lines insurers face considerable challenges in the current marketplace. Companies' need to generate profitable underwriting results has increased because of sustained low interest rates, which limit potential investment income, and the continued deterioration of historical loss-reserve cushions that have been used to help offset unfavorable underwriting results. The most successful surplus lines insurers are likely to be those that can maintain strong

relationships with their distribution partners and sustain strong retention levels, while using excellent technological platforms to ensure they operate at peak efficiency, providing a competitive edge.

Insurers have succeeded in pushing rate increases in the current market, particularly on the more troubled lines of business, but some lines of coverage remain competitive, with rates flat or close to it. In addition, since overall insurance capacity still exceeds demand, some industry observers and market participants believe rate increases already are showing signs of moderating in the second half of 2013. Those observers believe further positive rate movement may start to become challenging, except for the most distressed business, and in lines of coverage producing unfavorable results across most if not all territories and across different account sizes. However, with underwriting income more vital to an insurer's bottom line amid lagging investment returns, and with loss costs still trending upward, continued rate increases over the near term appear likely, particularly on commercial insurance, which comprises the vast majority of surplus lines business.

Shifting market dynamics notwithstanding, plenty of interest remains in specialty and surplus lines business. Private equity firms continue to express interest in specialty and surplus lines companies they feel have strong niches or discernible competitive advantages. Standard market carriers that have successfully used enhanced technology platforms to compete for portfolios of borderline surplus lines business may be concerned about average rate levels on some lines, but they still are looking to retain these accounts. In some cases, as business profiles have changed, some admitted writers now may consider this business core to their current strategies. Larger, traditional surplus lines risks that present higher hazards, however, often require specific loss-control and claims-handling expertise, which increases the expense of competing for this business. While surplus lines insurers may find fewer standard-market carriers to compete with for this business, they still will have to balance selectivity with the need to service brokers and ultimately policyholders with the desired customized insurance solutions. The development of expert capabilities on emerging, specialized liabilities always has been a trademark of the surplus lines industry, and brokers and insurers continue to count on it.

Effective management of underwriting, pricing and claim functions through deployment of enhanced predictive modeling and other analytical tools has helped insurers to better control expenses. These expense-cutting tools enhance the ability to profitably underwrite risks despite soft market conditions. Databases have improved markedly in recent years, making these analytical tools more useful. This helps decision-makers to determine which products, lines of coverage and risks offer acceptable profit margins. No matter how sophisticated the modeling tools are, however, well-thought-out and effectively executed strategies, along with underwriting discipline, are key drivers for surplus lines companies to successfully navigate the market.

Mergers and Acquisitions

As conditions softened after the last hard market, achieving top-line, organic growth in premium became extremely difficult. As a result, opportunistic consolidations have played a key role for some organizations in reaching desired top-line growth. Surplus lines companies and groups remained well capitalized despite the tough operating environment in recent years, but the possibility persists for weaker companies to be open to acquisitions by financially stronger partners.

There was relatively little M&A-related activity of note that progressed past the due diligence and discussion stage in 2012, compared with the number of deals completed just

a few years ago. Divergent views of potential sellers and buyers on company valuations; increasing rate levels that presented opportunities for organic growth; and the instability of financial markets were primary reasons for the lower M&A activity among P/C companies. The fragile nature of the economic recovery also likely is leading potential buyers with excess cash to hold it until they have a better feel for near-term economic conditions. The reserve risk associated with potential deals also is likely deterring some transactions, particularly larger scale acquisitions, which have resulted in many buyers later discovering inadequate reserves in acquired companies.

Surplus lines/specialty insurers such as RLI, Markel, Argo Group and Amtrust were involved in M&A deals that helped expand their reach and/or provide growth in desired lines of business or geographic areas. Heightened interest remains in purchasing managing general agents (MGAs) and underwriting managers involved in surplus and specialty lines business. These professionals generally have specialty expertise in niche classes of business, as well as relationships with the agents that can help generate the business. Insurance carriers interested in growth find these MGAs and underwriting managers very desirable targets.

M&A activity involving insurance agents and brokers reached record levels in 2012, with many deals involving middle-market surplus lines companies. Activity in 2013 may continue this trend, with lingering uncertainty as to how many potential deals actually are announced and subsequently completed.

In May 2013, Markel completed the acquisition of Alterra in a merger of top-30 surplus lines groups, based on 2012 DPW. Markel is optimistic that the deal will help to expand its book of large commercial account and reinsurance business. In addition to agreement on valuation, both strategic and cultural fit are key factors if the number of deals completed by the end of 2013 is to come close to the number of deals in 2012. A.M. Best expects interest in both broker/agency acquisitions and insurance company M&A transactions to persist as the shape of the changing market becomes clearer.

A.M. Best's View of the Surplus Lines Market

A.M. Best believes that given the recent overall uptick in rates, as well as the relative lack of natural catastrophe-related losses recorded in the first half of 2013, the surplus lines market is on track to produce an underwriting profit in 2013. However, the lingering effects of Superstorm Sandy and the sustained low interest rate environment still present challenges to the industry. Surplus lines writers also are noting that borderline surplus lines business, which had flocked to the admitted markets in recent years, slowly has been trickling back. While far from a traditional hard market, price increases that are sticking, as well as the flow of business from the admitted markets, are good signs for future top-line growth. A.M. Best believes that if overall economic indicators continue to improve, the need for capable surplus lines insurers to cover expanding exposures will increase, especially in industries such as construction, transportation and health care.

Results in the second half of the year could, however, be affected adversely by the predicted increase in hurricane activity for the 2013 season. Absent any major storm impacts, however, A.M. Best believes that with the current trends regarding rates, and increased focus on sound underwriting, year-end 2013 results could improve over year-end 2012 results. Lessons learned from Sandy also will be important, such as a renewed focus on underwriting, re-evaluation of product coverage and terms, and fresh scrutiny of geographical exposure to flood zones with the rollout of updated flood maps.

Rate adequacy will remain important because of stubbornly low interest rates, which have driven down investment returns in recent years. With few options available to boost investment income, surplus lines writers are expected to sharpen their focus on underwriting fundamentals, conservative pricing and technical efficiencies. Although overall rates have been trending upward for most lines of coverage (especially for more traditional, higher hazard surplus lines risks), it is important to note that some lower hazard classes and lines of business still have seen either relatively flat or declining rates in a highly competitive environment. The growth in premium volume over the past 12 to 24 months reflects ongoing recovery in the exposure base given an improving economic environment, combined with ongoing rate firming as market conditions improve. However, overall economic factors (interest rates, inflation and employment rates) will continue to present variables that likely will affect both top- and bottom-line results for the near term.

The favorable prior-year loss-reserve development domestic professionals have experienced in recent years exhibits the benefit of higher average rate levels. After another year of reserve releases in 2012, particularly on more recent accident years, A.M. Best feels reserve cushions are diminishing. As a result, A.M. Best remains concerned with the industry's loss-reserve position given the extended soft market cycle, which has eroded pricing and subsequently reduced the available loss-reserve cushion. However, with underwriting results remaining under pressure, A.M. Best expects the current trend of reserve releases for recent accident years to continue through the end of 2013, although at a reduced level compared with the industry's total reserve development in 2012. In addition, with the loss-reserve cushion in most companies disappearing, A.M. Best does not believe that companies will be able to use prior-year reserve releases to help offset inadequate current-year pricing for much longer.

In early 2013, surplus lines saw additional capacity and capital flowing into the marketplace. The most prominent news in this regard is the expected increase in Berkshire Hathaway's participation in the surplus lines market after the defection of senior executives from AIG. Berkshire is a market leader in handling tougher, more unusual exposures in its reinsurance book of business, so devoting greater resources to surplus lines business from a primary perspective should draw on competencies already in house. Berkshire has the capacity to make a significant splash in the market, particularly on larger, more complex risks; however, it is not yet clear how the group strategically looks to penetrate the market further.

Another matter of note is the overall improvement in enterprise risk management among companies in the surplus lines market. The very specialized and often non-commoditized risks often handled by surplus lines companies require very prudent analysis and assessment of prevailing risks to underwrite them profitably. As a result, most companies have expended significant resources in recent years to further refine their risk profiles and appetites, often making tough, strategic decisions to terminate underperforming programs, curtail sales of certain products or ultimately exit lines of business.

Over the past few years, the balance sheets of professional surplus lines carriers have withstood numerous challenges and maintained adequate strength to execute operating plans. Accident-year reserve development for professional surplus lines companies has been slightly more favorable than that experienced by the overall P/C industry, with the gap tightening as more business moved from the nonadmitted market to the admitted market. This has put the onus on insurers to be conservative and

accurate with their loss picks. If they succeed, reserve development still should have a positive near-term impact on companies in the surplus lines market.

Conclusion

Through the first half of 2013, general market conditions have continued the momentum that began during the second half of 2011, and extended through 2012, with up-pricing being the norm, and coverage terms and conditions showing more signs of tightening. In addition, similar to the first half of last year, catastrophe-related losses are down in the first half of 2013, providing reason for guarded optimism about year-end results. These will depend, in part, on the activity during the Atlantic hurricane season in the second half of the year. However, with the sustained low interest rate environment providing little investment return, underwriting performance once again will be the most important factor driving operating performance.

It is not yet clear whether competitive pressures and abundant capacity will cause pricing to moderate by the end of the year. A.M. Best believes some moderation already is occurring. This could be limited, however, by above-average catastrophe activity during the second half of the year, and/or if insurers overcome these limiting factors with their drive for underwriting profits to offset minimal investment gains. The performance of the commercial lines and surplus lines market segments in 2013 also will depend greatly on the extent to which macroeconomic factors such as sluggish economic growth and high unemployment enable market dynamics to impact bottom-line profitability.

Historically, the top surplus lines insurers have focused on maintaining the underwriting and pricing integrity that have been the hallmark of this market segment. These companies typically focus more on bottom-line profits than on top-line, organic growth, utilizing the segment's freedom of rate and form and the varied, nonstandard risks that are underwritten. This focus gives these insurers the best chance to withstand adverse markets and succeed over the long term.

The leading surplus lines groups that produce the lion's share of the market's DPW include organizations that have proved capable of managing their portfolios and successfully navigating the soft market environment. Most of the industry's leading groups have retained strong balance sheets, despite the competitive operating environment of recent years. Creating new, innovative products and insurance solutions, while enhancing technology platforms to provide customers with superior value-added services, almost certainly will remain important strategic components.

A.M. Best believes the commercial market segment can meet these challenges and produce improved underwriting results in 2013; however, it will take a continued focus on judicious underwriting and prudent risk management. In addition, personal lines pricing remains strong, with solid increases in direct premiums written (DPW) during the first quarter of 2013. Although rates have improved on most lines of business, overall pricing is not exhibiting the true characteristics of a traditional hard market. Therefore, insurers must take measured, careful rate increases, balancing the amount of rate needed to satisfy underwriting requirements with the ability to stay competitive in the chosen product lines. Although pricing in general continues to improve for a number of lines, some of the "fringe" classes of business that have been written in the admitted market, particularly certain general liability and property classes, are likely to find their way back into the surplus lines market at substantially higher rates and tighter terms and conditions as standard-market companies focus more resources on core books and classes of business. This likely would lead to results for the surplus lines market that again outpace those generated by the total P/C industry.

Section II – Financial Condition and Ratings Distribution

DPSL Peer Composite Overview

The domestic professional surplus lines (DPSL) peer composite (see sidebar **A.M. Best's DPSL Peer Composite Defined**) experienced a downturn in profitability in 2012, generating a 24.3% decline in pretax operating income and a 10.2% decline in net income. Net income, however, was still sizable at \$1.57 billion, compared with \$1.75 billion in 2011.

Maintaining the momentum from 2011, the composite reported increased growth in direct premium written (DPW) at 6.8% in 2012, compared with 3.1%, in 2011. This compares with 4.4% year-over-year growth for the P/C industry. Growth in 2011 marked the first year since 2006 that composite premium grew.

Despite the headwinds from competition, weather, the economy and low investment returns, the surplus lines composite continues to sustain operating profitability in the face of worsening underwriting results in each of the past three years. The recent increase in catastrophe-related losses affecting property lines, as well as higher pure loss ratios for the general liability, commercial multiperil and medical professional liability lines of business, have driven the less favorable underwriting results. The weather-related catastrophe activity of the past couple of years, most notably associated with Hurricane Irene and the Halloween storm of 2011, also included tornadoes, wildfires and hailstorms, in addition to tropical storms Beryl and Debby that preceded Superstorm Sandy in 2012.

Still, surplus lines companies continue to look for new opportunities and push for incremental rate increases in light of elusive investment returns. Rate firming seems to be fairly consistent across most lines of coverage during the past two years, but not to the extent required to drive a full-blown hard market. This behavior is partially due to the abundance of capacity in the marketplace, the sluggish U.S. economy and insureds' inability to accept large rate increases. In particular, rates have been firming on catastrophe-exposed property lines and on certain classes of business for general liability coverage in response to adverse profitability trends. A.M.

A.M. Best's DPSL Peer Composite Defined

The analysis in this section is based on the statutory financial data of 74 U.S.-based domestic professional surplus lines (DPSL) companies. To determine the population of true DPSL companies for the purposes of this section and the comparisons herein, A.M. Best excludes from this composite surplus lines companies that are members of inter-company pools that predominantly write admitted business as opposed to surplus lines; those companies that reinsure all of their business with an affiliate; and companies that write a relatively small amount of premium. This DPSL composite produced approximately \$14.0 billion in direct premiums written (DPW) in calendar year 2012, representing approximately 55% of the total U.S. DPSL market as defined in this report.

As noted in **Section I**, DPSL companies are identified as those that write at least half of their business on a surplus lines (or nonadmitted) basis. These organizations historically have accounted for approximately two-thirds to three-quarters of the total surplus lines market.

Best believes further price firming will be needed to make up for a diminishing impact on current calendar-year results from the dwindling inventory of reserves from earlier accident years.

P/C Industry Challenged to Limit Deterioration in Operating Results

Through more than nine months of 2012, the U.S. property/casualty (P/C) industry was headed for a substantial turnaround in financial results after 2011's significant underwriting loss. Despite low interest rates that were not expected to improve markedly anytime soon, the industry (including the mortgage and financial guaranty segments) generated net income that was substantially ahead of the 2011 pace, buoyed by a steadily firming rate environment; a stabilizing economy despite high, though improving, unemployment rates; and lower levels of weather-related losses.

The arrival of Superstorm Sandy on Oct. 29 dramatically changed the course of the year for P/C insurers and was clearly felt on insurers' income statements, with the underwriting result worsening from a loss of \$7.4 billion through the third quarter to more than \$16.0 billion by year end. Sandy's impact notwithstanding, several P/C industry results in 2012 appear to portend further improvement in 2013. The industry's net premiums written and policyholders' surplus increased year over year in 2012, and this momentum was sustained through the first quarter of 2013. The P/C industry's reported loss and loss-adjustment expense ratio in 2012 improved to 74.3 from 79.4, and its combined ratio was also better at 103.1, compared with 108.2 in 2011.

The industry's total investment return was essentially break-even based on net investment income and realized gains; however, a substantial increase in unrealized gains helped drive the 6.4% increase in policyholders' surplus for the year. The pricing environment is expected to continue improving as well, although A.M. Best believes signs of some moderation in the overall price firming during the first quarter could prove to be the prevailing trend throughout the rest of 2013. Although improvement in the macroeconomic environment continues to be sluggish, low investment yields persist, and the industry's current loss-reserve position will present challenges, A.M. Best believes the overall market is well-capitalized enough to meet and overcome those challenges.

For the P/C industry, A.M. Best expects the challenging operating environment to present continuing difficulties for companies in maintaining the current momentum toward better operating results. These challenges reflect:

- Difficulty of generating improved investment yields in a depressed interest rate environment.
- Persistent, broad macroeconomic concerns.
- Uncertainty regarding the level and sustainability of rate firming over the near term.

Further reduction in the industry's loss-reserve cushion in 2012 is another key determinant of the results P/C insurers posted in 2012, especially in the commercial lines segment. More of the same is expected in 2013.

The DPSL composite's combined ratio (after policyholder dividends) increased considerably to 110.5 in 2012, up from the 103.7 recorded in 2011. This increase was primarily due to the large jump from an underwriting loss of \$371.9 million in 2011 to a loss of \$812.7 million in 2012. Losses associated with the aforementioned weather-related events, in addition to an increase in the pure net loss ratio for the composite's lead general liability line of business, were the principal drivers of the larger underwriting loss.

Operating Performance

Through 2011, the DPSL composite's results clearly outpaced those of the total P/C industry (including the mortgage and financial guaranty market segment), as reflected in the composite's 100.3 and 92.9 five- and 10-year combined ratios compared with 103.9 and 100.8, respectively, for the P/C industry. In 2012, however, a reversal of fortune occurred, as the P/C industry saw its pretax and net income increase by 119.2% and 85.0% respectively, while the DPSL composite results declined by 24.3% (pretax income) and 10.2% (net income). Despite generating sizable profits, the surplus lines composite clearly trailed the total P/C industry across several key metrics.

Up until 2012, the DPSL composite historically maintained a slightly more favorable underwriting expense ratio than the total P/C industry. As with other key profitability measures, the calendar-year results for 2012 were counter to historical norms, with the DPSL composite's expense ratio slightly exceeding that of the total P/C industry. While commissions paid by surplus lines insurers are typically higher than for the P/C industry, an increase in the composite's net commission ratio was the primary reason for the higher underwriting expense ratio in 2012. This stemmed from a 27% increase in ceded reinsurance premium with minimal change in ceding commission.

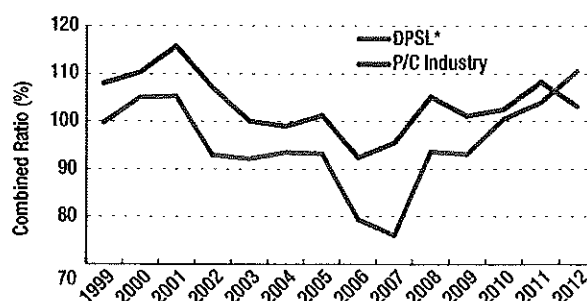
The surplus lines composite's reported 2012 combined ratio of 110.5 was 7.4 percentage points higher than the P/C industry's 103.1 (see **Exhibit 10**). For the most part, the deterioration in the surplus lines composite's results in 2012 was due to Superstorm Sandy and the losses sustained in New York and New Jersey, the fourth- and sixth-largest states for the composite in terms of DPW produced. Less favorable reserve development also contributed to the drop in underwriting profits.

Despite the setback, the surplus lines composite (as well as the P/C industry) experienced a 2.5% increase in net premiums earned (NPE) in 2012.

Impact of Weather-Related Losses

The unprecedented number of catastrophe events in the United States in 2011 was the primary driver behind the composite's rise in LAE, which at that time reached a 10 year high (see **Exhibit 11**). However, during 2012, this ratio fell back in line but was offset by Sandy and the corresponding jump in the composite's pure net loss ratio.

Exhibit 10
U.S. DPSL* Composite vs. P/C Industry – Combined Ratios (1999-2012)



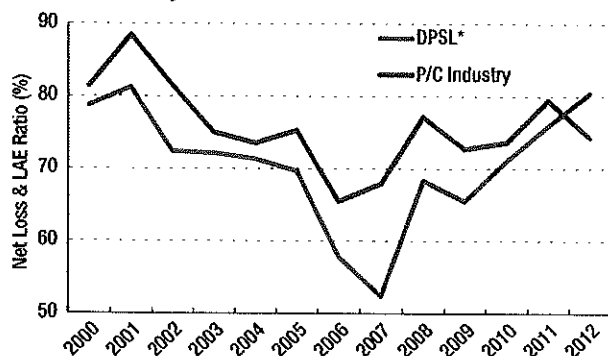
* Domestic professional surplus lines
Source: A.M. Best data & research.

Perhaps the most pronounced disparity between surplus lines insurers and the P/C industry is in allied lines.³ A.M. Best believes this disparity reflects the unique, customized nature of this business and the various coverage options that are tailored to certain risks. Sandy-related losses are included in allied lines.

The spread between the DPSL allied lines loss ratio and that of the P/C industry widened from 58.0 points in 2010 to approximately 92.0 points in 2011 and a whopping

106.0 points in 2012, due to Sandy. In 2012, allied lines for the surplus lines composite finished the year at a 197.4 pure net loss ratio (excluding LAE), while the P/C industry ended the year at 90.9. The extraordinary loss ratio also reflects the surplus lines industry's risk appetite and its willingness to write coastal properties in areas where standard carriers may not.

Exhibit 11
U.S. DPSL* Composite vs. P/C Industry –
Net Loss & Loss-Adjustment Expense Ratios
(2000-2012)



* Domestic professional surplus lines
Source: A.M. Best data & research.

In response to the impact of past weather events on results and the potential impact of future weather events on underwriting profitability, more companies are putting greater effort into incorporating recent loss data in their current pricing models and exposure management decisions. Surplus lines companies have been active in enhancing the quality of data collection

and in augmenting the sophistication of the modeling tools used to help make decisions on management of aggregate exposure and pricing decisions on catastrophe-exposed risks.

The greater frequency and severity of catastrophe losses in recent years has had a material impact on ultimate calendar-year results for the total industry, especially for the DPSL composite. However, the surplus lines industry is able to partially mitigate these losses because of its freedom to set pricing and coverage terms.

Investment Income Falls, but Net Investment Gain Rises

The DPSL composite's net investment income – primarily dividends from stocks and interest on bonds – declined by 3.0% year over year in 2012, while the P/C industry experienced a similar decline of 4.2%. A substantial, 84.0% increase in investment allocation to short-term investments and cash, along with fewer dollars invested in long-term bonds, contributed to the decline in investment income for the DPSL composite, since the shorter term investments carry relatively low interest rates. In addition, lower interest earned on fixed-income securities, as well as an increase in allocated funds to short-term investments and cash, have impacted the investment income generated by the P/C industry as a whole. Possibly looking to offset some of the income lost from the shift toward short-term investments and cash, both the composite and the P/C industry increased investments in equity securities during 2012.

In 2012, the composite's realized gains (more than \$416.0 million) and unrealized gains (more than \$631.0 million) on investments led to a 45.0% increase in the

³Allied lines insurance refers to coverage generally written in conjunction with fire/property insurance that includes coverage for windstorm and hail, sprinkler leakage, water damage, etc.]

total capital gain (net investment income plus realized gains or losses), as shown in **Exhibit 12**. The majority, more than 60%, of the unrealized gain was generated among composite members that are part of Berkshire Hathaway. The P/C industry similarly experienced a considerable, more than 39.0% increase in its net investment

Exhibit 12

U.S. DPSL* Composite vs. P/C Industry – Investment Performance

(\$ Billions)

	DPSL 2011	DPSL 2012	Year/Year Change (%)	Total P/C Industry 2011	Total P/C Industry 2012	Year/Year Change (%)
Net Investment Income	\$2,188.0	\$2,121.9	-3.0	\$51,370.0	\$49,237.0	-4.2
Realized Capital Gains or (Losses)	231.1	416.4	80.2	7,579.0	9,033.0	19.2
Net Investment Gain	2,419.1	2,538.3	4.9	58,949.0	58,270.0	-1.2
Unrealized Capital Gains or (Loss)	(232.70)	631.2	-371.3	(3,678.0)	18,823.0	-611.8
Total Capital Gain or (Loss)	2,186.4	3,169.5	45.0	55,271.0	77,093.0	39.5

* Domestic professional surplus lines

Source: A.M. Best data & research

gain. In both cases, a substantial turnaround from an unrealized loss position on securities owned to a notable unrealized gain was the catalyst for this surge in net investment gain.

Favorable Loss-Reserve Development

Over the past few years, favorable prior-year loss-reserve development has augmented the overall P/C industry's underwriting profitability. Favorable development reduced the DPSL composite's combined ratio by 7.3 points in 2012, which was less than the 10.3 points of positive impact recorded in 2011. These reserve takedowns compare favorably with the 2.8- and 2.9-point reductions in 2012 and 2011, respectively, for the total P/C industry.

In the near term, A.M. Best believes favorable reserve development may continue, but at a lower magnitude than in recent years as the reserve cushion is likely to dissipate. In 2012, commercial lines reserves developed favorably, equating to 3.2 points on the segment's combined ratio. A.M. Best believes that loss reserves for the P/C industry are already deficient for commercial insurers, and reserve margins are tightening greatly as well. As such, A.M. Best believes reserve margins for surplus lines insurers also are constricting. Despite this, both groups are expected to post reserve redundancies in 2013. A.M. Best also believes the insurers that have reserved conservatively will be best positioned to take advantage of market opportunities through the cycle.

Commercial casualty reserves (combining the other liability, medical professional liability and products liability lines), which in 2012 made up almost 80% of the surplus lines composite's reserve base, take longer to establish loss-payout patterns. As such, A.M. Best is cautious in its view of the impact of recent accident-year takedowns and their future effect on the composite's reported underwriting profitability.

The DPSL composite's reported accident-year combined ratio, which excludes prior-year loss-reserve development, was 115.9, moderately worse than the 110.3 posted in 2011 and noticeably higher than the 103.4 reported in 2009. This result reflects the increase in weather-related catastrophe losses and negative trends in specific lines of coverage for the composite, such as general liability, medical professional liability and commercial auto liability.

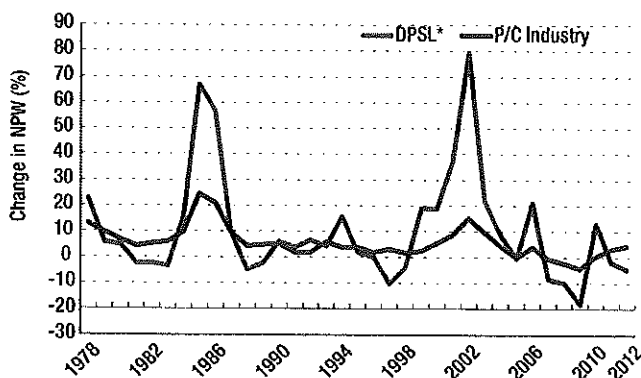
Comparatively, the P/C industry's reported accident-year combined ratio was 105.6, down from 109.0. Improvement in the profitability of the homeowners and commercial multiperil lines of coverage spurred the lower accident-year combined ratio for the P/C industry. However, A.M. Best remains concerned that a number of P/C insurers, including surplus lines companies, continue to be too optimistic about loss trends, which could lead to the premature release of loss reserves, particularly from accident years that have yet to mature.

DPSL's Growth Rate Less Than Total P/C Industry's

In 2012, the DPSL composite posted a 6.8% increase in direct premiums written, making 2012 the second consecutive year for growth in this sector. Conversely, net premiums written for the DPSL composite contracted 4.8% in the year (see **Exhibit 13**). As mentioned previously, this reduction in NPW was driven primarily by a considerable amount of premiums ceded to third-party reinsurers. Results for the most recent five years show surplus lines insurers with a compound annual growth rate (CAGR) in NPW of -4.5%, compared with 0.4% for the total industry. This in part shows the overriding impact of prolonged competitive market conditions on surplus lines insurers compared

with the rest of the market, with standard market companies competing for traditional surplus lines accounts.

Exhibit 13
U.S. DPSL* Composite vs. P/C Industry – NPW Growth (1978-2012)



* Domestic professional surplus lines
Source: A.M. Best data & research.

The five-year change in NPW reflects the composite's greater contraction in net premiums, at -20.7%, compared with the P/C industry's 2.2% increase. The shift of business out of the surplus lines market and into the admitted market exemplifies the standard market's historical willingness to write some borderline classes of business in the admitted market, especially some general liability and property classes, during particularly competitive periods in the market cycle. It also reflects both the impact of weak macroeconomic

factors and the discipline of surplus lines insurers, particularly the market leaders.

DPSL Outperforms Total P/C Industry in Overall Profitability

Although the surplus lines composite's underwriting performance clearly has been less favorable over the past few years than in previous years (2002-2009), the DPSL composite's overall operating profitability, as measured by returns on revenue, has remained solid and superior to that of the total P/C market, as demonstrated by the one-year and five-year average returns on NPE (see **Exhibit 14**).

Both the surplus lines composite and the overall P/C industry experienced an uptick in total return on surplus (equity). The composite still outpaced the total P/C industry by a small margin, producing a 9.7% return, up from 6.8% in 2011 (see **Exhibit 15**). The higher total return for the composite was directly attributable to the huge turnaround from an unrealized loss of more than \$232.0 million in 2011, to an unrealized gain of \$631.1 million in 2012. The instability in global financial markets, combined with the sustained low interest rate environment over the past few years, has led to the composite's volatile unrealized investment gains and losses. Likewise, the P/C industry benefited from a positive change in 2012, posting a huge,

\$18.8 billion unrealized gain during the year after experiencing a loss of almost \$3.7 billion in 2011.

While the composite's returns on surplus also have compared favorably with the total industry, the difference is less significant than the margin for returns on revenue (earned premium). This is because the surplus lines market historically has maintained lower underwriting leverage than the P/C industry. Surplus lines insurers, in meetings with A.M. Best during the latter portion of 2012 and through the first half of 2013, have reported the continuation of rates trending upward and prices firming for most commercial lines of business and in most territories.

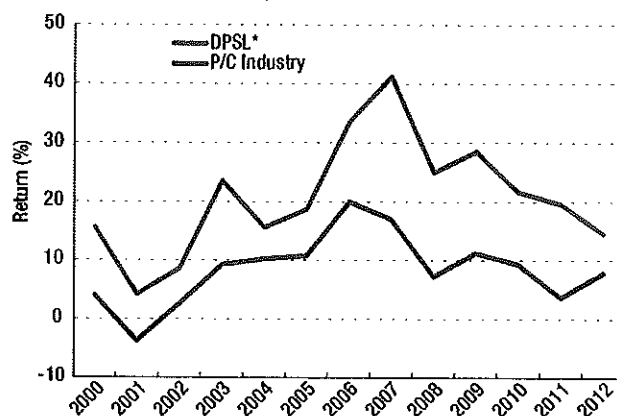
A.M. Best believes price increases still are needed on commercial property and workers' comp business in the overall P/C industry. The property line is the second largest for the DPSL composite in terms of DPW and NPW. A.M. Best also believes the second half of 2013 will find ongoing momentum for rate increases, coupled with positive cash flows and retained earnings fortifying companies' balance sheets to combat challenging market conditions for the core commercial lines segment. As noted earlier, this segment is integral to the performance of the surplus lines market.

Balance Sheet Strength

Surplus lines insurers generally remain very well capitalized, as these companies need strong balance sheets given the unique or more hazardous risks they insure. Since these insurers typically provide more complex and flexible coverage options than standard market carriers, conservative underwriting fundamentals are extremely important. In addition, persistent, intense competition in the marketplace, coupled with low investment returns and recent catastrophic events, has heightened the focus on solid, profitable underwriting. Despite the relatively soft market conditions in recent years, the surplus lines insurers generally have been adequately managing the market cycle and maintaining their conservative balance sheet strength with passive investment strategies and improving income levels through rate increases. This remains particularly true of the leading surplus lines carriers.

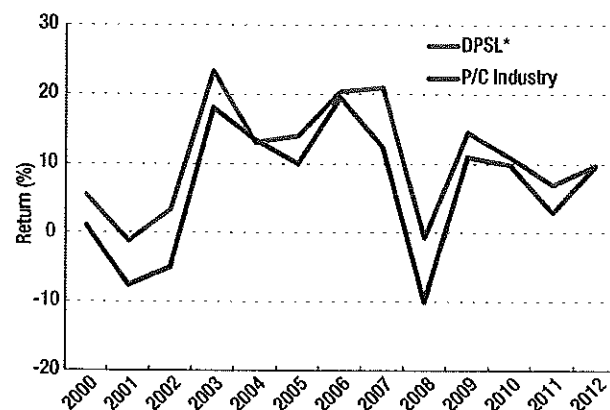
Overall, surplus lines insurers continue to benefit from their largely strong capital base, which better positions these companies to withstand periods of heightened competition, low interest rates and weather-related catastrophe losses, while still maintaining more than adequate capitalization.

Exhibit 14
U.S. DPSL* Composite vs. P/C Industry – Pretax Returns on Net Premiums Earned (NPE) (2000-2012)



* Domestic professional surplus lines
Source: A.M. Best data & research

Exhibit 15
U.S. DPSL* Composite vs. P/C Industry – Total Returns on Surplus (2000-2012)



* Domestic professional surplus lines
Source: A.M. Best data & research.

In 2012, the DPSL composite's policyholders' surplus grew by 4.6% despite an underwriting loss of nearly \$813.0 million and relatively flat investment income the past three years. Surplus grew in 2012, driven primarily by the run-up in the equities markets generating \$631.0 million in unrealized capital gains and \$416 million in realized capital gains.

The P/C industry's 85.0% growth in net income, combined with more than \$9.0 billion in realized gains, led to a 6.4% increase in policyholders' surplus. Over the long term, however, the DPSL composite's growth in surplus – 160% over the past 10 years – is considerably greater than the 107% change for the total P/C industry.

In 2012, the DPSL composite continued to maintain slightly lower net premium leverage (the ratio of NPW to policyholders' surplus) than the total P/C industry. The composite also maintained lower net leverage (net premium leverage plus net liability leverage). The composite's gross leverage measure (net leverage plus ceded reinsurance leverage), at 2.5 times surplus, also was below the total industry average of 3.0 times surplus. Surplus lines companies historically have used reinsurance to protect their balance sheets to a slightly greater degree than the total industry, reflecting the higher limits provided as well as larger catastrophe exposure associated with property risks. This results in higher ceded leverage, comparatively.

The DPSL composite's strong risk-adjusted capitalization is supported further by its relatively conservative investment portfolio, with U.S. government and National Association of Insurance Commissioners (NAIC) Class 1 bonds making up the vast majority of total invested assets. In addition, a conservative loss-reserve position augments the composite's capitalization.

Ratings Distribution

Over the past 10 years, DPSL insurers consistently have maintained a higher proportion of "Secure" ratings than the overall P/C industry (see **Exhibit 16**). A Secure rating is defined as an A.M. Best rating in the range from A+ (Superior) to B+ (Very Good). As of late August 2013, all of the A.M. Best-rated DPSL rating units held secure ratings.

The term "rating unit" applies either to individual insurers or to a consolidation of affiliated companies. The rating unit forms the financial basis upon which A.M. Best performs its rating evaluation.

The percentage of DPSL insurers in the top-tier rating categories, Excellent to Superior, relative to all rating opinions remained extremely high at almost 97.9% (95 out of 98 rating units in the top tier), essentially the same as last year's 98.0% (101 of 103 rating units). The number of rating units declined during the past year, due in part to intragroup consolidations involving organizations such as W. R. Berkley Insurance Group and QBE North America Group, which used new quota-share reinsurance or reinsurance pooling agreements that resulted in multiple rating units merging into single rating units. In the years before 2012, the number of rating units had grown through the influx of smaller, start-up companies and the impact of some companies becoming single, affiliated rating units and no longer a part of group rating units as defined by A.M. Best.

For the total P/C industry, rating units in the Excellent to Superior rating categories decreased, with 76.0% of the ratings in the top tier compared with 73.2% one year before. In concert with these statistics, DPSL companies continue to enjoy a higher rating median of A, compared with A- for the overall P/C industry.

Exhibit 16

U.S. Domestic Professional Surplus Lines vs. P/C Industry – Best's Rating Distribution by Rating Unit

Best's Financial Strength Rating (FSR)	Domestic Professional Surplus Lines		Total P/C Industry		
	Category	# of Rating Units	Percentage	# of Rating Units	Percentage
SECURE RATINGS					
A++	Superior	5	5.1%	19	2.1%
A+	Superior	20	20.4%	74	8.3%
	Subtotal	25	25.5%	93	10.5%
A	Excellent	51	52.0%	293	33.0%
A-	Excellent	19	19.4%	289	32.5%
	Subtotal	70	71.4%	582	65.5%
B++	Good	3	3.1%	104	11.7%
B+	Good	0	0.0%	60	6.7%
	Subtotal	3	3.1%	164	18.4%
Total Secure Ratings		98	100.0%	839	94.4%
VULNERABLE RATINGS					
B	Fair	0	0.0%	30	3.4%
B-	Fair	0	0.0%	10	1.1%
	Subtotal	0	0.0%	40	4.5%
C++	Marginal	0	0.0%	1	0.1%
C+	Marginal	0	0.0%	3	0.3%
	Subtotal	0	0.0%	4	0.4%
C	Weak	0	0.0%	5	0.6%
C-	Weak	0	0.0%	1	0.1%
	Subtotal	0	0.0%	6	0.7%
D	Poor	0	0.0%	0	0.0%
E	Under Regulatory Supervision	0	0.0%	0	0.0%
F	In Liquidation	0	0.0%	0	0.0%
	Subtotal	0	0.0%	0	0.0%
Total Vulnerable Ratings		0	0.0%	50	5.6%
Total Rating Opinions		98	100.0%	889	100.0%
Total NR Ratings		1		1,054	
Total Reported Rating Units		99		1,943	

1 Domestic professional surplus lines ratings are as of Aug. 28, 2013

2 Total industry ratings distribution data are as of June 18, 2013

Source: A.M. Best data & research

Outlook

The DPSL composite started 2013 with solid results in the first quarter, reporting almost \$300.0 million in net underwriting income and approximately \$786.0 billion in pretax income. The improvement in underwriting profitability led to a 99.1 combined ratio, driven by a 60.4 loss and loss-adjustment expense ratio. These results compared favorably with a reported combined ratio of 103.4 and a loss and LAE ratio of 69.4 through the first quarter of 2012. The loss ratio was aided by 5.4 points of favorable prior accident-year development, which was essentially on par with the impact of favorable development on the P/C industry's first-quarter loss ratio.

The sustained low interest rate environment, coupled with a lack of risk-averse investment alternatives, likely will continue to make it difficult for insurers to offset underwriting losses with investment gains. As a result, the renewed focus on underwriting

profitability will remain paramount to a company's overall bottom line and, ultimately, to its balance sheet strength.

While the P/C industry's numbers were much improved in 2012, the impact of Sandy likely will be felt for some time. A renewed focus on profitable underwriting, spurred by insurers reviewing their geographic exposure based on new flood maps and updated catastrophe models, will be an important trend to follow over the near term.

Looking further at first-quarter 2013 results and trends for the total P/C industry, pretax income was \$16.8 billion and net income was \$22.2 billion, spurred by an underwriting gain of \$6.9 million (compared with a \$0.1 billion underwriting loss in the first quarter of 2012). Underwriting profitability also improved year over year, as evidenced by a 64.4 loss and loss-adjustment expense ratio and a 92.8 combined ratio for the P/C industry at the end of the quarter, compared with ratios of 70.0 and 98.9, respectively, in 2012. These underwriting results were augmented by 6.1 points of favorable impact on the combined ratio from current-year development of prior accident years' reserves. Compared with a more modest 3.7 points of positive impact in the first quarter of 2012, the 6.1 points of favorable development was somewhat surprising. It runs counter to A.M. Best's belief that the depth of reserve redundancies that can positively impact current calendar years' results is diminishing and will have less of an impact on future calendar-year profitability.

Growth in the P/C industry's premiums in the first half of 2013 appears to be driven by the favorable impact of rate increases throughout the personal lines segment and a hardening of rates in select commercial lines of business. While pricing has firmed in the majority of commercial lines, there were indications at midyear that the overall pace of rate increases may be decelerating.

A.M. Best believes overall rate changes should remain in positive territory as long as interest rates remain at record lows. However, while continued rate increases are likely, it is not yet clear whether the recent pace will be maintained and whether the pace of commercial up-pricing exceeds future loss costs and inflation. Additionally, the economy remains in recovery mode and there is still sufficient market capacity, which likely will prevent a return to a full-blown hard market in the near term.

The compilation of second-quarter total P/C industry results has not been completed at this writing. Although the lesser frequency of weather-related catastrophe losses in the first quarter was offset somewhat by problems associated with tornadoes and wildfires in certain areas of the country, A.M. Best expects the results for the P/C industry to continue improving. With only incremental improvement in pricing conditions expected for the remainder of the year, potential losses from the current Atlantic hurricane season, which ends Nov. 30, are a major concern as always for the surplus lines market and the total P/C industry. As in past years, the magnitude of those potential losses will be a key determinant of year-end profitability.

The threats of both natural and man-made catastrophes should continue to drive greater underwriting discipline and oversight. Predictive modeling provides a more sophisticated means of attracting better priced business, and some insurers continue to use this tool to minimize losses and maximize profits. A.M. Best expects the surplus lines market segment to continue exhibiting disciplined underwriting, resulting in sustained operating profitability and balance sheet strength.

Section III: Regulation and Legislation

Several pieces of legislation relating to the surplus lines industry have been introduced in the 113th Congress (2013-2014). They relate to timely issues and are of particular concern to the insurance industry in general. Some bills have been introduced in anticipation of existing legislation expiring, i.e., the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA). Some have been reintroduced from previous congressional sessions, such as the National Association of Registered Agents and Brokers Reform Act (NARAB II), which passed the House, 397-6, on Sept. 10. Both federal and state legislation and regulations are detailed in the chart below, and this section also updates progress in implementing the Nonadmitted and Reinsurance Reform Act of 2010, known as the NRRA.

2013 Federal Legislation/Regulation	Key Provisions
<p>National Association of Registered Agents and Brokers Reform Act. Known as NARAB II (H.R. 1155 and S 534)</p> <p>113th Congress - Reintroduced by Rep. Randy Neugebauer, R-Texas (H.R. 1155) and Sen. Jon Tester, D-Mont. (S 534).</p> <ul style="list-style-type: none"> • Reintroduced in the 112th Congress by Neugebauer (H.R. 1112) and Tester (S 2342) • Introduced in the 111th Congress by Reps. David Scott, D-Ga., and Neugebauer (H.R. 2554) • Previous versions were passed in the House but not the Senate 	<ul style="list-style-type: none"> • NARAB II would streamline and improve the licensing process for approved nonresident insurance producers, eliminating duplicative licensing requirements for businesses operating in multiple states. This act would improve the licensing process for nonresident insurance producers and strengthen oversight by state insurance regulators. • Would create the National Association of Registered Agents and Brokers (NARAB). It would allow nonresident insurance producers, after meeting and maintaining certain eligibility criteria, to operate in states where they pay a licensing fee. • Would preserve state insurance regulation and consumer protection provisions. • Would help surplus lines brokers by facilitating the acquisition of nonresident surplus lines licenses. • Last Action: 9/10/2013. H.R. 1155 passed by House, 397-6.
<p>Terrorism Risk Insurance Program Reauthorization Act (TRIPRA)</p> <ul style="list-style-type: none"> • H.R. 508; introduced by Rep. Michael Grimm, R-N.Y. • H.R. 1945 introduced by Rep. Bennie Thompson, D-Miss. • H.R. 2146 introduced by Rep. Michael Capuano, D-Mass. 	<p>In November 2002, the Terrorism Risk Insurance Act was passed to provide a government reinsurance backstop so that commercial insurers would offer terrorism coverage. The act – extended and amended in 2005 and 2007 and now known as the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) – is set to expire on Dec. 31, 2014.</p> <p>The looming expiration has created uncertainty among insurers throughout 2013 as they renew their commercial policies. In the event TRIPRA is not renewed or its protection is altered materially, insurers would have to obtain private reinsurance if they don't have it already.</p> <p>Three bills, designed to extend the program by either five or 10 years, have been introduced in the House of Representatives to reauthorize the act. They are:</p> <p>H.R. 508 Terrorism Risk Insurance Act of 2002 Reauthorization Act of 2013</p> <ul style="list-style-type: none"> • Introduced on Feb. 5, 2013, and referred to the House Financial Services Committee <p>H.R. 1945 Fostering Resilience to Terrorism Act of 2013:</p> <ul style="list-style-type: none"> • Introduced on May 9, 2013, and referred to the House Financial Services Committee and to House Homeland Security Committee. • On May 29, 2013, referred to the Cybersecurity, Infrastructure Protection, and Security Technologies Subcommittee. <p>H.R. 2146 Terrorism Risk Insurance Program Reauthorization Act of 2013:</p> <ul style="list-style-type: none"> • Introduced May 23, 2013, and referred to the House Financial Services Committee.

2013 Federal Legislation/Regulation	Key Provisions
<p>Flood Insurance Reform Act of 2012</p> <ul style="list-style-type: none"> • H.R. 5740 Introduced in the 112th Congress by Rep. Judy Biggert, R-Ill., to amend the National Flood Insurance Act of 1968. • H.R. 1485 Introduced in the 113th Congress by Rep. Frank LoBlundo, R-N.J. • H.R. 1267 Introduced in the 113th Congress by Rep. Steven Palazzo, R-Miss. 	<p>H.R. 5740 – Before Superstorm Sandy, in July 2012, the Biggert-Waters Flood Insurance Reform Act of 2012 was passed. It calls on the Federal Emergency Management Agency (FEMA) and other agencies to change the way the National Flood Insurance Program (NFIP) is run.</p> <p>Key provisions of the legislation require the NFIP to raise rates to reflect true flood risk (a 25% increase in premium rates each year), make the program more financially stable and change how Flood Insurance Rate Map updates impact policyholders.</p> <p>Floods caused by Sandy further compromised the NFIP's financial stability, as it is estimated by the Congressional Research Service to add between \$12 billion and \$15 billion to the NFIP's debt. In 2013, other legislation to amend NFIP has been introduced, but with an approach that would result in less of a premium increase. They include:</p> <p>H.R. 1485 – Introduced April 11, 2013. Would amend the National Flood Insurance Act of 1968 to modify the phase-in of increases in flood insurance premium rates for certain properties (at a rate of 12.5% a year for eight years.)</p> <p>H.R. 1267 – Introduced March 19, 2013, and referred to the House Financial Services Committee. For certain properties, it would freeze NFIP rates at their current level for one year and would slow rate increases over the next 10 years by phasing out insurance subsidies over a longer period.</p>
2013 State Level Legislation/Regulation	
California	<ul style="list-style-type: none"> • AB 1236: This bill would amend Section 7071.19 of the Business and Professions Code relating to contractors. It would allow contractors registered as limited liability corporations (LLCs) to procure liability coverage from an eligible surplus lines insurer. This bill awaits the governor's signature.
Connecticut	<ul style="list-style-type: none"> • HB 6379, signed into law June 21, 2013 (Public Act 13-171): It eliminates the diligent search affidavit requirement. In lieu of an affidavit, licensees and insureds are required to submit signed statements that coverage is not available in the admitted market after a diligent search. The amount of coverage procured in the nonadmitted market is limited to the portion not available on an admitted basis. Effective Oct. 1, 2013, statements are to be filed quarterly and due on the 15th of February, May, August and November.
• Louisiana	<ul style="list-style-type: none"> • HB 543, signed into law June 10, 2013 (Public Act 203): It authorizes surplus lines insurance regardless of whether authorized insurance is available. It also removes many regulations and sets different regulations for this type of insurance.
North Dakota	<ul style="list-style-type: none"> • HB 1181, signed into law April 2, 2013: It authorizes domestic surplus lines insurers to operate in the state.
Virginia	<ul style="list-style-type: none"> • HB 2155: This bill would make technical changes to facilitate the transfer of the administration of premium license tax from the Insurance Commission to the Department of Taxation.
State Reporting Changes	The following states issued bulletins or legislative changes regarding their reporting structure for surplus lines taxes:
Alaska	<ul style="list-style-type: none"> • Bulletin B13-01: The Division of Insurance has modified reporting requirements. All new and renewal policies effective Jan. 1, 2013 and later, and all endorsements and audits invoiced Jan. 1, 2013 and later, must be reported on a quarterly basis, with the quarterly report sent to the Division of Insurance.
South Dakota	<ul style="list-style-type: none"> • Bulletin 12-06: The bulletin requires all single-state surplus lines policies issued or renewed after Jan. 1, 2013, and any subsequent endorsements to those policies, to be filed through the NIMA Surplus Lines Clearinghouse. Policies with effective dates or endorsements before that date will continue to be filed with the South Dakota Insurance Department until renewal.
• Tennessee	<ul style="list-style-type: none"> • HB 144/SB 150, passed as Public Chapter 444 on May 16, 2013; effective Jan 1, 2014: This amends Tennessee Code Annotated, Title 56, Chapter 14, Section 113. It establishes that the premiums charged for surplus lines insurance are subject to a gross premium tax, less any return premiums, for surplus lines insurance provided by the surplus lines agent pursuant to the license. It determines that when the insurance covers an insured whose home state is Tennessee, the sum payable shall be computed based on an amount equal to 5% of the gross premiums, less the amount of gross premiums allocated within the state and returned to the insured. It also establishes March 1 of each year as the annual payment date.
• Texas	<ul style="list-style-type: none"> • HB 1405, signed into law June 14, 2013: It allows managing general agents and surplus lines agents to enter a written agreement whereby the surplus lines agent is responsible for all filing and tax-payment requirements.
• Wyoming	<ul style="list-style-type: none"> • Memorandum 01-2013: It states that all single-state policies issued or renewed on or after April 1, 2013, and any subsequent endorsements to those policies, shall be filed with the NIMA Surplus Lines Clearinghouse. Surplus lines filers were to begin filing transactions with the Clearinghouse on April 1. Single-state policies with an effective date before April 1, or endorsements on those policies, will continue to be filed with the Wyoming Insurance Department until renewal.
Source: Library of Congress, National Association of Professional Surplus Lines Offices, Ltd. (NAPSLO).	

Update on Nonadmitted and Reinsurance Reform Act of 2010 (NRRA)

State governments continue to adapt to the provisions of the Nonadmitted and Reinsurance Reform Act of 2010, with 49 having enacted legislation to implement the NRRA over the past two years. Setting aside previous rules that placed regulatory and tax jurisdiction in the state or states where a risk was located, the NRRA set in motion the following reforms related to surplus lines/nonadmitted insurance:

- Fixed the regulation and taxation of surplus lines transactions on the home state of the insured, i.e., a commercial insured's principal place of business or an individual's state of residence.
- Established uniform, nationwide eligibility standards based on two sections of the National Association of Insurance Commissioners' Nonadmitted Model Act for U.S.-domiciled nonadmitted insurers. The model act defines an eligible surplus lines insurer as being authorized in its state of domicile to write the coverage being offered on a nonadmitted basis; and meeting specified capital and surplus standards. The NRRA also requires states to allow licensed surplus lines brokers to place or procure insurance from any alien (non-U.S.-based nonadmitted insurer) that is on the NAIC Quarterly Listing of Alien Insurers.
- Created a nationwide definition of an exempt commercial purchaser (ECP), applicable in each state, for which a broker can access the surplus lines market without the need for a diligent search.

The NRRA also authorized states to form compacts or other mechanisms to allocate premium taxes paid to an insured's home state, and called on each state to adopt nationwide, uniform requirements, forms and procedures for the reporting, payment, collection and allocation of surplus lines premium taxes.

The home-state approach to regulation and taxation has governed every surplus lines transaction since the NRRA took effect on July 22, 2011. The uniform eligibility standards also affect every surplus lines company or nonadmitted company wishing to write surplus lines insurance, and by extension, this affects every surplus lines transaction. The states have universally accepted the use of the NAIC's quarterly list for alien (non-U.S.) company eligibility and the NRRA's two-prong national test for eligibility of U.S.-based nonadmitted insurers.

Some states have moved to create their own "voluntary" lists of eligible U.S.-based carriers. California's interpretation, like most other states, is that the NRRA no longer allows a mandatory "white list" of eligible surplus lines insurers. Instead, in 2011 the California Insurance Code was amended to establish the List of Approved Surplus Line Insurers (LASLI), an optional listing brokers may rely upon. Approved carriers on this list have been reviewed for compliance with California capitalization levels, quality of assets, and officer and director backgrounds – but insurers not on the list also may meet these criteria.

Louisiana in 2013 became the latest state to migrate from a mandatory to a voluntary listing. While these lists are voluntary for carriers, many may feel compelled to participate, lest their absence from the list place them at a disadvantage in the market.

The National Association of Professional Surplus Lines Offices (NAPSLO) supports efforts to maintain strong supervision of surplus lines insurers' solvency, including some

highly sophisticated tools that have been developed at the state level. But the association would oppose any effort to gather data beyond what states and the NAIC already collect for purposes of solvency regulation.

The nationwide definition of exempt commercial purchaser (ECP) found in the NRRA does not affect every surplus lines transaction as the other reforms do, since it is limited to large, sophisticated commercial buyers. Since some states already had their own definition of an ECP, not every state adopted the NRRA definition.

While the NRRA recognized that the “states may enter” tax-sharing arrangements for surplus lines premium tax, 46 jurisdictions currently do not participate in any such arrangement. Tax sharing for surplus lines would only impact a small number of transactions and a limited amount of premium, since it only applies to transactions with multistate exposures. These are estimated to be around 5% of surplus lines transactions.

After the enactment of the NRRA, two tax-sharing models were put forth under which states could share surplus lines tax revenue: the Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT) and the Nonadmitted Insurance Multi-State Agreement (NIMA). Only NIMA, with a membership of six jurisdictions (Florida, Louisiana, South Dakota, Wyoming, Utah and Puerto Rico), has become viable. Recently, the Florida Surplus Lines Service Office, which acts as the clearinghouse for NIMA, has sought to expand NIMA’s membership by inviting other jurisdictions to join the NIMA clearinghouse on a trial basis.

Section IV – Current Distribution Issues

Surplus lines intermediaries have a number of reasons to feel good about their place in the insurance world: changes in taxation are simplifying their business processes; a trend of steady growth looks sustainable; and opportunities to expand by acquisition are rewarding to the acquirers without upsetting the overall market. In interviews with a number of surplus lines distributors, A.M. Best found a generally positive outlook, tempered by some frustration over the continuing inability of states to achieve uniformity – even with the streamlined taxation regime provided by the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA).

A.M. Best also surveyed surplus lines insurers to gauge the relative shares of premium running through various types of intermediaries, and how widely used each type of distributor is. The results are discussed later in this section.

Home-State Filing: A Liberating Change

Two years after implementation of the NRRA, producers are enjoying marked improvement in the process of allocating taxes among states, and the enactment of home-state filing on multistate risks is seen as a significant step forward. Implementation at first varied among states, leading to some confusion. Nevertheless, with all states now on board, either through legislation or practice, many distributors are seeing greater efficiency, quicker processing and reduced costs. Some are finding compliance easier, and there is less need for information gathering from clients to meet varying state requirements that prevailed before the NRRA took effect. Compliance staff is being reduced in some instances.

Producers now have greater confidence that they're paying the correct taxes and face fewer instances of having to re-file – a cost producers likely would absorb rather than pass along to insureds. One effect of home-state filing may be to encourage some local and regional brokers to expand their territory, knowing that the tax-allocation process is much simpler than before.

Lingering inconsistencies among states tend to be in areas not addressed by the NRRA. Perhaps most troublesome is the continued need in many cases for brokers and insurers to reconcile their different reporting of premium on multistate risks. Brokers generally report 100% to the insured's home state under the NRRA, while statutory accounting may call for insurers to allocate reported premium among various states. Insurers and brokers report expending much time and effort on reconciliation under rules that do not account for the differences between the NRRA and statutory annual statement instructions.

Further, reporting and payment of taxes is annual in some states, quarterly in others and monthly in still others. Each state uses different forms and methods for filing, ranging from web-based to paper. But as brokers and industry groups work with individual state regulators to implement the NRRA's provisions, some states are upgrading their technology, which in turn may address some of the remaining divergence in filing requirements and methods. Another area not covered by the NRRA is business placed through risk purchasing groups, which may be led by an association based in one state but have members in multiple states. Home-state filing does not generally apply to such groups.

Within the scope of the NRRA, some outlier states are defining certain products differently from the majority, or still seek to split taxes on multistate policies. And the NRRA leaves room for tax-sharing compacts among states, which have gained limited traction but do add complexity where they exist.

Submissions, Premiums Maintain Upward Trajectory

As surplus lines distributors master the new taxation regime, they are applying it to a steadily increasing flow of submissions and premiums into the market. The gradual upward trend has spanned the past few years, in contrast with how the events of Sept. 11, 2001 sharply escalated the turn that was underway at that time. More rapid growth in surplus lines is occurring in catastrophe-exposed regions and lines of business, especially along the Gulf, Southeast and Northeast coasts, as carriers judiciously manage their capacity in these areas. By line, distributors cited growth in energy risks, construction, employment practices liability, directors and officers, and real estate related coverages, though competition persists in some of these lines. Other segments such as professional and general liability and noncoastal property may better be described as firming than trending upward, except for specific, loss-hit accounts.

An improving economy has helped lift surplus lines as it has the property/casualty industry in general; many brokers pointed to rejuvenated building activity and a general rebound in payrolls as driving upswings in construction-related coverages. More business is crossing over from the admitted market as rates increase steadily, though not dramatically for the most part. With a stubbornly flat investment environment, some carriers are pushing explicitly for targeted, albeit modest, increases in rates across books of business. This can put brokers in a squeeze if competitors are still able to offer lower rates through other carriers.

Submissions to surplus lines brokers, meanwhile, are up as much as 20%, although binding rates are holding steady. Unlike in past cycles, however, standard carriers are not declining or nonrenewing whole lines of business but instead are looking account by account to decide which business to keep. Some business continues to leak back into the standard market, but less than in the recent past.

Certain pockets – as broad as New York construction and Texas energy, or as specific as snow plowing in the Northeast – are seeing especially sharp movement to the surplus lines market and increases in rates. In the Northeast, Superstorm Sandy seems to have marked a turning point toward greater acceptance by insureds of price increases, while promoting greater awareness of flooding risk among surplus lines carriers.

Surplus lines are benefitting from continuing innovation in the creation of new or improved products for clients. For example, in the sale of a company, transactional insurance can cover the buyer or seller for representations and warranties made by the parties to the agreement. In some cases, the concepts of the coverage aren't new, but surplus lines insurers are driving the evolution and development of products to keep pace with customers' needs.

Meanwhile, changes in the reinsurance market, with new facilities and sources of capital, also are influencing the market's capacity. With pricing already competitive in many lines of reinsurance, capital markets players in the segment are extending their reach not only within catastrophe lines of business, but also in specialty and casualty classes.

Survey Says...

The distributors with the greatest presence in the surplus lines market continue to be wholesale agents and brokers without binding authority, according to a survey of surplus lines writers developed and administered by A.M. Best with NAPSLO. More than half of respondents reported selling through this channel (see **Exhibit 17**), which accounted for 46% of the premium volume for this group of insurers. Retail producers

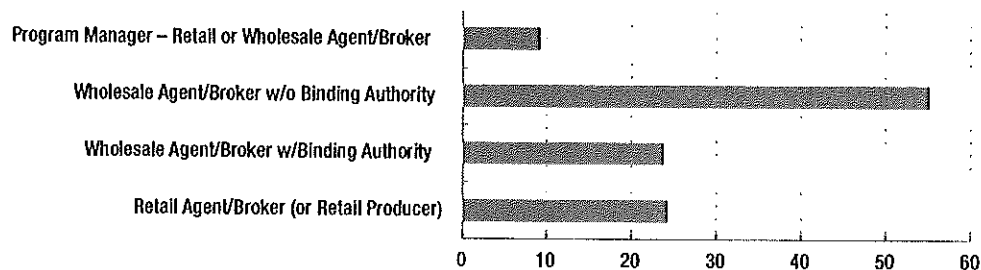
ranked a distant second, used by about one-quarter of surplus lines insurers, but ranked third in terms of premium volume at 19% (see **Exhibit 18**). Wholesale agents and brokers with binding authority were close behind in terms of popularity with surplus lines insurers, and ranked second in terms of premium volume at 25%. Program managers trailed far behind – near 10% by both measures. No respondents reported selling through direct procurement.

The survey drew 17 responses from insurers covering a wide range of sizes, with 2012 surplus lines direct premium written ranging from less than \$100 million to more than

Exhibit 17

U.S. Surplus Lines – Insurers' Use of Distribution Channels (2012)

Based on responses to A.M. Best distribution survey.
(%)



Note: Total exceeds 100% because most insurers use more than one distribution channel.
Source: A.M. Best Surplus Lines Distribution Survey

\$1 billion. Together the respondents had surplus lines direct premium written of \$5.9 billion. Median surplus lines premium of respondents was \$229.3 million, and the mean was \$344.6 million.

While respondents across the board favored distribution through wholesale producers without binding authority, those with premium volume above the median were more likely to rank producers with binding authority as their No. 2 method, while those below the median tended to rank retail channels second. Just two respondents reported running their entire surplus lines premium through a single channel; both had premiums below both the median and mean. One of these used exclusively wholesale producers without binding authority, while the other used only retail producers.

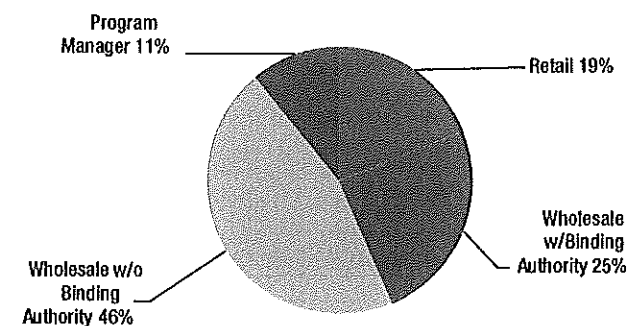
M&A Serves Individual Agendas

Mergers and acquisitions appear to be helping active acquirers toward targeted growth, sometimes by crossing between the various distribution categories. But the overall competitive landscape is little affected by the trend toward consolidation. Some smaller brokers chose to remain independent, perhaps hoping to ride out a trough in valuations. Now they see continued demand for their services, working on the premise that there

Exhibit 18

U.S. Surplus Lines – Share of Premium by Distributor Type (2012)

Based on responses to A.M. Best distribution survey.



Note: Total exceeds 100% due to rounding.
Source: A.M. Best Surplus Lines Distribution Survey

will always be a place in the market for quality service, regardless of the provider's size. These firms have a shrinking field of peers, but there has been little overall impact on their operating environment.

When retailers turn acquisitive, wholesalers with strong ties to them can reap substantial benefits as they gain access to a wider array of agencies. In some cases, retail brokers are forming alliances and networks, which also can cut favorably or unfavorably for the wholesalers that are chosen or excluded by those consortiums.

As some carriers do more business through wholesalers with binding authority, some large, wholesale brokers are moving into that space by acquiring smaller players such as managing general agents, or hiring away teams of underwriters from such firms to bring binding authority in house.

Many branch offices of wholesalers, perhaps 10%, have closed over the past several years, and few have reopened. But on the retail side, the number of independent agencies has reversed a prolonged decline, ticking upward to 38,500 in 2012 after reaching a low of 37,500 in 1996, according to the 2012 Agency Universe Study published by the Independent Insurance Agents and Brokers of America. Some surplus lines distributors see this as a healthy counterpoint to the trend of consolidation in recent years.

Private equity has heated up transaction activity among brokers, with such investors buying directly into the business or providing capital for acquirers. A sampling of recent deals around the industry includes:

- AmWins Group in December 2012 agreed to acquire Georgia-based Gresham & Associates Inc., a wholesale broker and managing general agent (MGA) with \$340 million of annual premium.
- Brown & Riding and Travis Pedersen & Associates agreed in December 2012 to a merger that the companies said created a national top 10 wholesale brokerage based in Los Angeles.
- Atlas General Insurance Services agreed in April 2013 to acquire South Bay Underwriters LLC from Bliss & Glennon, a national MGA and surplus lines broker.
- R-T Specialty LLC, the wholesale arm of Ryan Specialty Group LLC, in September 2012 acquired wholesale brokerage Atlantic Star Intermediaries LLC.
- RLI Corp. in November 2012 acquired Rockbridge Underwriting Agency, an MGA specializing in surplus lines medical professional liability insurance.

Making Technology Work With People

In mergers there is always the task of integration, which can be highly challenging in the realm of marrying or making the transition between technological platforms. Surplus lines distributors, like many other businesses, see enormous gains in efficiency tied to the use of technology – and sometimes lament their industry's collective status as a late adopter.

But there is also a greater dependence on human expertise in surplus lines than in other, more commoditized lines of insurance. Technology in this business is a tool to facilitate transactions and put better information in the hands of the people who still make the deals.

The holy grail of technology for some producers – one-time data entry that can carry a risk through from submission to binding and issuance of a policy – remains as elusive as ever after a decades-long quest. Some distributors are increasingly frustrated with the slow progress and are back to attempting to devise their own ways of connecting with various proprietary systems, rather than relying on collective efforts. Others, however, still hold out hope for shared or third-party systems that can interface with multiple carriers. The desire to reach the goal may depend in part on the size of the distributor, with larger players tending to push harder for a common platform.

Short of that goal, producers still see significant gains in efficiency across all aspects of the business, thanks to electronic communication and documentation of the entire insurance transaction. There is growing attention to the point of sale, providing clients with amenities such as online rating tools.

Another potential use of technology is to analyze a book of business, much as a carrier would, to gauge performance and set priorities: what a firm can do well, what may need to be set aside and where opportunities lie for new products and services. But in their interface with distributors, carriers vary widely in their sophistication; some have yet to adopt e-signatures, for example, and some cancellation notices still arrive by “snail mail.”

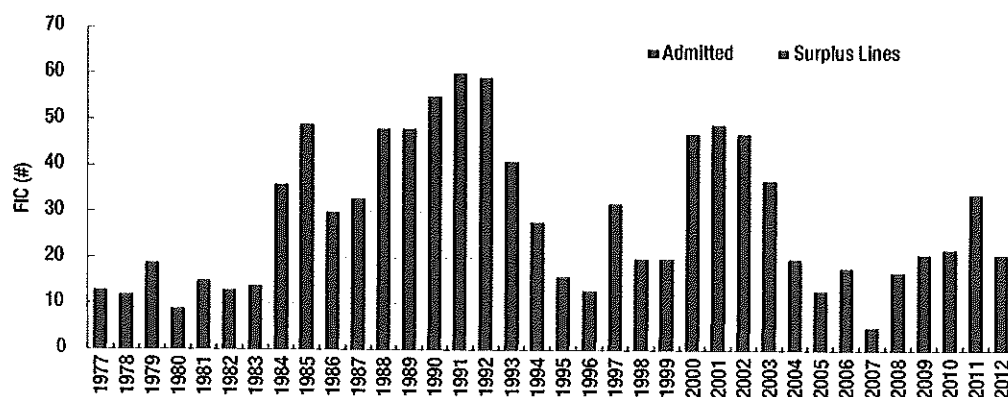
Focus on Efficiency

Efficiency is advancing on multiple fronts in surplus lines distribution, including faster service through technology; streamlined regulation; and economies of scale through M&A. These improvements complement the vital human interactions that sustain the industry through phases of heavy demand and through leaner periods. Time likely will separate the innovators from the laggards as this evolution challenges distributors to keep up or bow out of the surplus lines market.

Section V: Impairment Trends

In 2012, for the ninth year in a row, the surplus lines industry reported no financially impaired companies (FICs). This was in marked contrast to the admitted property/casualty (P/C) industry's 21 disclosed financial impairments for the year (see **Exhibit 19**).

Exhibit 19
U.S. Admitted Companies vs. Surplus Lines –
Annual Impairment Count (1977-2012)



Source: A.M. Best data & research

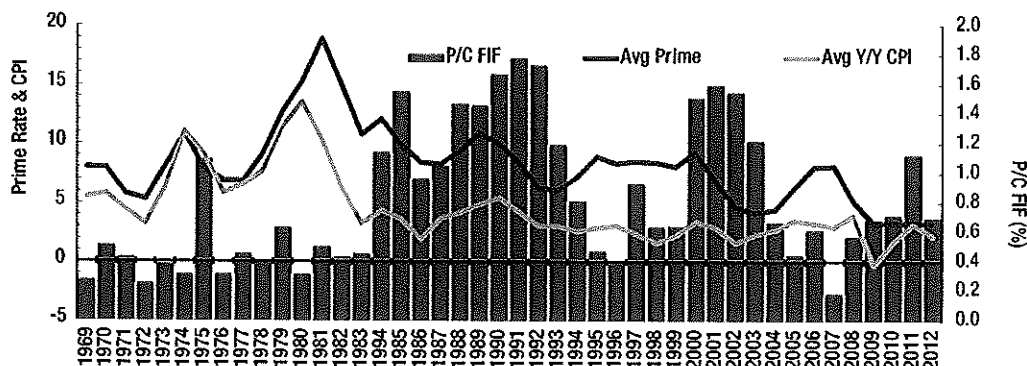
So far, four admitted P/C companies have been reported impaired in 2013. Additional financial impairments for 2012 and 2013 could emerge, however, because state insurance departments have been reluctant to report a financial impairment until they have exhausted all means to rehabilitate or facilitate a sale or merger of the insurer.

The 21 P/C FICs for 2012 represented a drop from the 34 impairments for 2011. They also were below the industry's historical average impairment count of 25.8. The 2012 average financial impairment frequency (FIF) – a more accurate indicator of financial impairment trends than a mere count – was 0.69%, below the industry's historical average of 0.82%. The FIF is calculated using the number of companies that become impaired in a given year, divided by the number of companies operating in the insurance market in that year.

Most of 2012's P/C industry FICs reflect the weak U.S. economy and the industry's overall deteriorating operating performance. Many of the FICs had been weakening over the past three or four years because of several factors, including soft market conditions, high underwriting losses and poor management decisions. Only one 2012 FIC – a homeowners writer – was the direct result of shock catastrophe losses. More than a third of the total 2012 impairments were in auto liability, which has seen a marked increase in severity of bodily injury claims. A.M. Best Co. rated six of the 2012 FICs, but none was in the "Secure" category.

A.M. Best has found increases in the insurance industry's FIF correlate strongly with preceding negative operating environments marked by events such as stock market booms and busts; economic recessions; and extraordinary cat losses that typically force the end of soft markets (see **Exhibits 20 and 21**). Evidence of these trends resides in the increased FIF rates during the periods 1988 to 1993 and 2000 to 2003. Rating trends are a key indicator of the financial health and stability of the insurance industry, because the trend in downward rating actions generally accelerates before impairments increase.

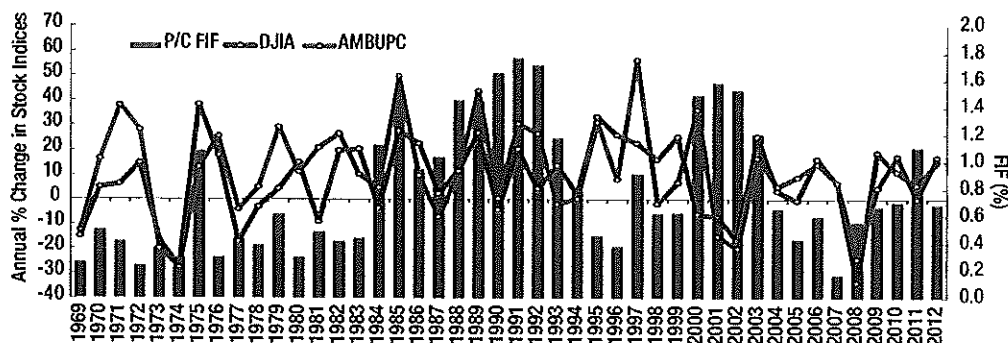
Exhibit 20
U.S. P/C Financial Impairment Frequency vs. Economic Climate* (1969-2012)



*Shaded areas represent official recessions.

Source: A.M. Best data & research, **BESTLINK** Best's Statement File – P/C US, Bureau of Labor Statistics, Federal Reserve Board, National Bureau of Economic Research

Exhibit 21
U.S. P/C Financial Impairment Frequency vs. Stock Indices (1969-2012)



Source: A.M. Best data & research, **BESTLINK** Best's Statement File – P/C US, Dow Jones & Co.

As of the publication date of this report, A.M. Best has maintained a negative rating outlook on the commercial lines segment. Among all P/C insurers, including admitted companies, the negative rating pressure was felt most widely in the catastrophe-exposed property and workers' compensation lines of business. Cat-exposed property is a significant surplus lines exposure, but the effect of workers' comp on surplus lines insurers is negligible because Louisiana is the only state that allows primary workers' comp to be written on a nonadmitted basis.

The majority of the negative rating actions were the result of weather-related losses, adverse prior-year loss-reserve development and/or inadequate rates, which some companies could not effectively absorb without materially reducing their risk-adjusted capital positions. (For domestic professional surplus lines ratings distribution, see **Section II: Financial Condition and Ratings Distribution.**)

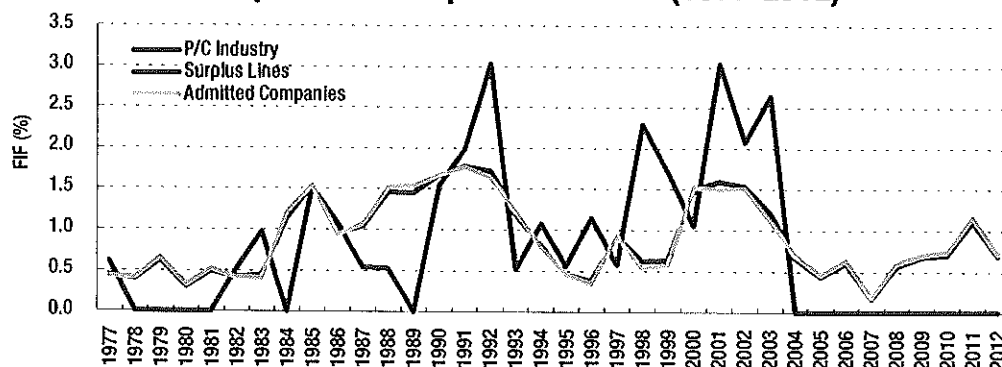
Surplus Lines Impairment Experience

Despite the absence of surplus lines financial impairments from 2004 to 2012, the surplus lines average FIF of 0.88% from 1977 to 2012 remains close to the admitted company average impairment rate of 0.89%. This reflects the surplus lines industry's significantly higher impairment frequencies during certain periods, in particular 1996, 1998, 1999 and 2001-2003 (see **Exhibit 22**). Since 2003, however, the impairment frequen-

cies for admitted and surplus lines companies have been converging with each year that the surplus lines industry has experienced no financial impairments (see **Exhibit 23**). (Note that a prior A.M. Best impairment review, in January 2012, identified Financial Benefits Insurance Co. as an impaired surplus lines insurer in 2011, when in fact at the time of its impairment, it was writing business as an admitted insurer.)

Exhibit 22

U.S. Admitted Companies vs. Surplus Lines – FIF (1977-2012)



Source: A.M. Best research, **BESTLINK** Best's Statement File – P/C US

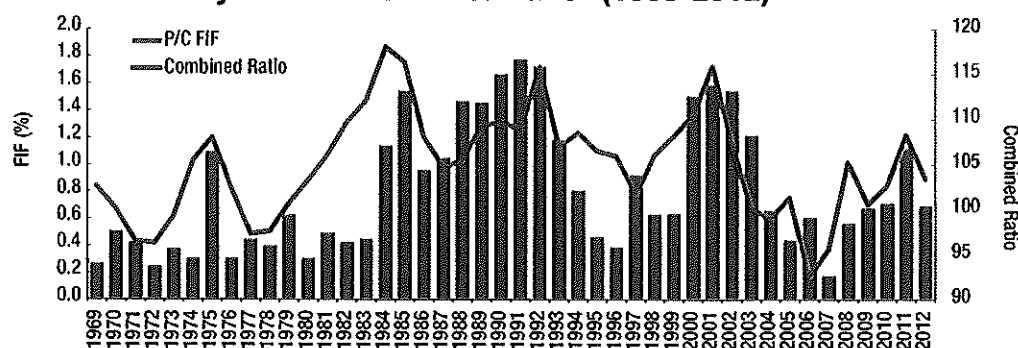
Exhibit 23

U.S. P/C Industry vs. Surplus Lines Companies – FIC Count & Frequency (1977-2012)

Year	Financially Impaired Companies (FIC)			Financial Impairment Frequency (FIF) ²			Year	Financially Impaired Companies (FIC)			Financial Impairment Frequency (FIF) ²		
	P/C Industry	Surplus Lines	Admitted Cos. ¹	P/C Industry	Surplus Lines	Admitted Cos. ¹		P/C Industry	Surplus Lines	Admitted Cos. ¹	P/C Industry	Surplus Lines	Admitted Cos. ¹
1977	13	1	12	0.44	0.62	0.43	1998	20	4	16	0.62	2.29	0.53
1978	12	0	12	0.39	0.00	0.41	1999	20	3	17	0.63	1.70	0.57
1979	19	0	19	0.62	0.00	0.66	2000	47	2	45	1.50	1.05	1.53
1980	9	0	9	0.30	0.00	0.32	2001	49	6	43	1.59	3.03	1.49
1981	15	0	15	0.49	0.00	0.52	2002	47	4	43	1.54	2.07	1.50
1982	13	1	12	0.42	0.52	0.41	2003	37	5	32	1.21	2.64	1.11
1983	14	2	12	0.44	0.98	0.40	2004	20	0	20	0.66	0.00	0.70
1984	36	0	36	1.13	0.00	1.21	2005	13	0	13	0.43	0.00	0.46
1985	49	3	46	1.54	1.52	1.54	2006	18	0	18	0.60	0.00	0.64
1986	30	2	28	0.95	1.08	0.94	2007	5	0	5	0.17	0.00	0.18
1987	33	1	32	1.04	0.54	1.07	2008	17	0	17	0.56	0.00	0.60
1988	48	1	47	1.46	0.53	1.52	2009	21	0	21	0.67	0.00	0.70
1989 ³	48	0	48	1.45	0.00	1.54	2010	22	0	22	0.71	0.00	0.74
1990	55	3	52	1.66	1.54	1.67	2011	34	0	34	1.11	0.00	1.16
1991	60	4	56	1.77	1.99	1.76	2012	21	0	21	0.69	0.00	0.72
1992	59	6	53	1.72	3.03	1.64	1977-2012	1013	55	958	0.89	0.84	0.89
1993	41	1	40	1.18	0.52	1.22	1 Includes alternative markets.						
1994	28	2	26	0.80	1.08	0.79	2 Failure frequencies are annualized rates.						
1995	16	1	15	0.46	0.56	0.45	3 1989 figures have been adjusted from previous reports to exclude 7 U.K.-domiciled companies.						
1996	13	2	11	0.38	1.15	0.34	Source: A.M. Best data & research, BESTLINK Best's Statement File – P/C US						
1997	32	1	31	0.92	0.58	0.94							

The absence of surplus lines impairments in the mid-2000s related primarily to the surplus lines industry's improved underwriting performance (i.e., underwriting discipline and adequate pricing). Other reasons for the lower impairment trend included improved systems and technology and better management reporting and oversight. However, since 2007, underwriting profitability and operating performance have been deteriorating, as indicated by the surplus lines industry's combined ratio (see **Exhibit 24b**). As such, the absence of impairments in the latter 2000s and early 2010s has been related more to the overall capitalization of surplus lines companies than to underwriting performance.

Exhibit 24a U.S. P/C Industry – FIF vs. Combined Ratio* (1969-2012)



*Combined ratios are after policyholders' dividends. A combined ratio below 100 indicates an underwriting profit; above 100, an underwriting loss.

Source: A.M. Best data & research, *BESTLINK* Best's Statement File – P/C US

Exhibit 24b U.S. DPSL Composite* – FIF & Combined Ratio (1997-2012)

Year	FIF	Combined Ratio	Year	FIF	Combined Ratio
1997	0.58	93.8	2006	0.00	79.4
1998	1.72	98.5	2007	0.00	76.1
1999	1.70	99.8	2008	0.00	93.6
2000	1.05	105.0	2009	0.00	93.1
2001	3.54	105.3	2010	0.00	100.5
2002	2.07	93.0	2011	0.00	105.1
2003	2.64	92.2	2012	0.00	110.5
2004	0.00	93.5			
2005	0.00	93.2			

* A.M. Best's peer composite of 72 domestic professional surplus lines companies.

Source: A.M. Best data & research

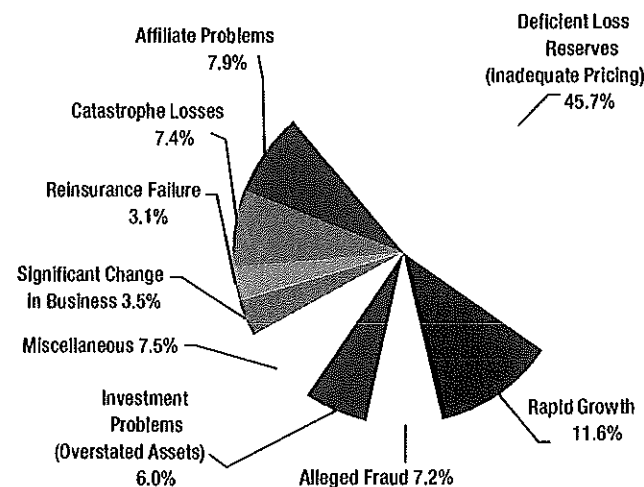
A.M. Best remains guardedly optimistic about the low trend in surplus lines impairments, with the offsetting factors being related to weak economic conditions that have prolonged the soft market and contributed to increasing combined ratios. Since 2008, the surplus lines industry also has not been able to offset any inadequacies in pricing with investment returns and capital markets. In addition, catastrophic losses in 2011 reached unprecedented highs.

Causes and Characteristics of Financial Impairments

The causes and characteristics of financial impairments have remained generally consistent for both surplus lines and the admitted P/C industry over the course of A.M. Best's impairment study, most recently updated in the special report *U.S. Property/Casualty – Impairment Review*.

Accounting for the largest portion of impairments among surplus lines and admitted companies were the related categories of deficient loss reserves/inadequate pricing and rapid growth (see Exhibits 25a and 25b). These two categories in combination accounted

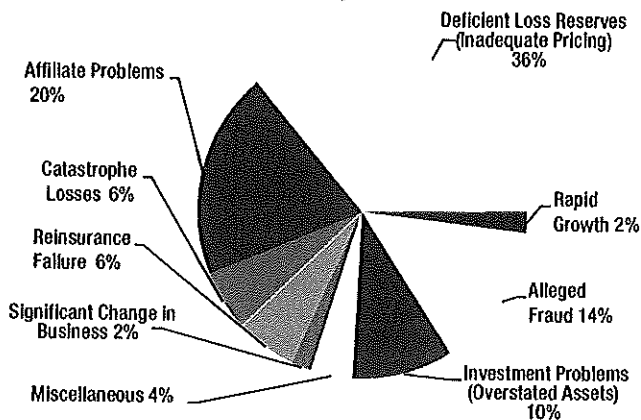
Exhibit 25a U.S. P/C Admitted – Primary Causes of Impairment (1977-2012)



Note: Exhibit % based on companies where the cause of impairment was identified.

Source: A.M. Best research

Exhibit 25b U.S. Surplus Lines – Primary Causes of Impairment (1977-2012)



Note: Exhibit % are based on companies where the cause of impairment was identified.
Source: A.M. Best data & research

for 38.0% of surplus lines impairments and 57.3% of admitted P/C company impairments.

Contributing to the surplus lines figures were the increased impairment experience among program writers that relied heavily on managing general agents (MGAs) and the underwriting authority afforded to these agents. The surplus lines failures of the past highlight the extent to which poorly managed program operations of a parent company can impact its surplus lines affiliates.

Confirming this finding is that the second-highest cause of surplus lines impairment has been affiliate problems, at 27.3%. **Exhibits 25a and 25b** show that surplus lines had

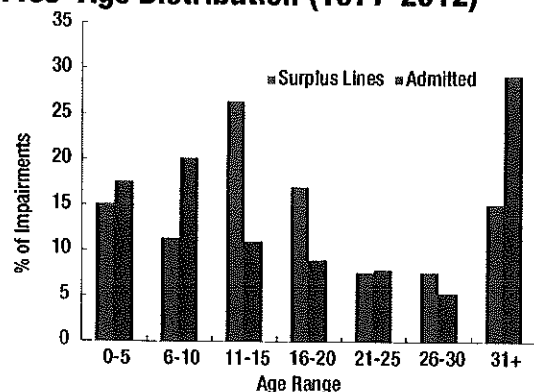
a significantly higher portion of impairments due to affiliate problems than did the admitted P/C companies, at 20.0% vs. 7.9%, respectively. Some surplus lines companies became impaired when their parent companies, which were engaged primarily in the admitted market, were declared insolvent.

The next highest cause of impairment among surplus lines companies was fraud, at 14.0% vs. 7.2% for admitted companies. All other causes of impairment for both surplus lines and admitted insurers accounted for less than 10% of the identified impairments. A.M. Best believes all insolvencies are related to some form of mismanagement, except those directly related to catastrophe losses. Companies impaired because of cat losses tend to have been concentrated in one line of business and/or geographic area or to have been weakened by several years of operating losses, and the shock losses became the last nail in the coffin.

As with admitted companies, surplus lines impairments overall tend to involve younger, smaller companies. At the time of impairment, almost 53% of the identified surplus lines companies were 15 years or younger (see **Exhibit 26**). Also at the time of impairment, 54% of failed surplus lines companies had less than \$5 million in surplus, while 73% had less than \$10 million in surplus (see **Exhibit 27**).

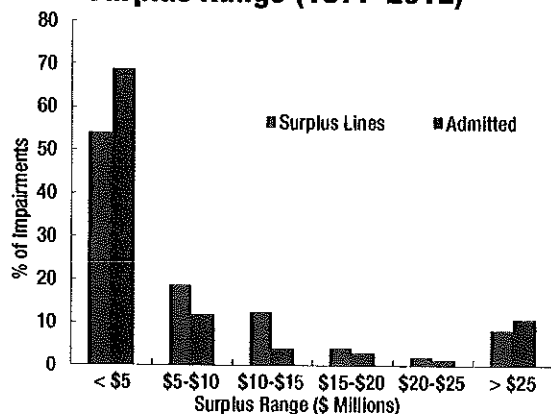
Looking at impairments by line of business, **Exhibit 28** shows the “other liability” category

Exhibit 26 U.S. Surplus Lines vs. Admitted – FICs' Age Distribution (1977-2012)



Note: Exhibit % based on companies for which age was identified
Source: A.M. Best data & research

Exhibit 27 U.S. Surplus Lines vs. Admitted – FICs' Surplus Range (1977-2012)



Note: Exhibit % based on companies for which surplus was identified. Surplus restated into 2012 dollars based on Consumer Price Index.
Source: A.M. Best research, **BESTLINK** Best's Statement File - P/C US

- directors and officers (D&O), errors and omissions (E&O), general liability, contractual liability, excess and umbrella - accounted for the highest percentage of surplus lines impairments over the course of A.M. Best's impairment study, followed by workers' comp and commercial auto. Again, workers' comp is not a significant surplus lines exposure, but a surplus lines insurer's impairment could result from adverse workers' comp experience of one or more admitted insurers in the same group of companies.

Surplus Lines Impaired Company Ratings Development

A.M. Best has analyzed the ratings development of financially impaired surplus lines companies in this study, beginning three years before the year of impairment. As noted earlier and shown in Exhibit 29, there generally is a steady degradation in ratings in the three years before impairment, with a slight increase in the Secure "B" category in the three years prior to impairment as the Secure "A" companies are downgraded into the Secure "B" category.

Overall, the higher the rating, the lower is the risk of impairment. Over the course of this study, 1977-2012, of the surplus lines impaired insurers with A.M. Best financial strength ratings or the equivalent, two of the 55 surplus lines impaired writers were in the Secure "A" or "B" rating category in the year of impairment; 21 were in the Vulnerable category; and the remaining companies were not rated or not formally followed by A.M. Best.

Financially Impaired Companies Defined

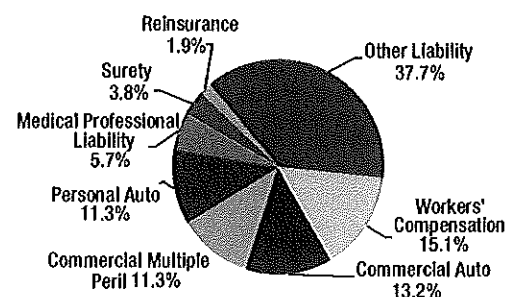
A.M. Best designates an insurer as a Financially Impaired Company (FIC) as of the first official regulatory action taken by an insurance department, whereby the insurer's:

- Ability to conduct normal insurance operations is adversely affected;
- Capital and surplus have been deemed inadequate to meet legal requirements; and/or
- General financial condition has triggered regulatory concern.

State actions include supervision, rehabilitation, liquidation, receivership, conservatorship, cease-and-desist orders, suspension, license revocation and certain administrative orders. A.M. Best emphasizes that the FICs in this study might not technically have been declared insolvent.

Note that the above definition of an FIC is broader than that of a Best's Rating of "E" (under regulatory supervision), which is assigned only when an insurer is "no longer allowed to conduct normal, ongoing insurance operations." Thus, a company may be designated as financially impaired in this study but may not have been assigned an "E" Best's Rating. Further, a Best's Rating of "F" (in liquidation) can reflect a liquidation as part of the impairment process, or it can indicate a voluntary dissolution. Unless they occur under financial duress, voluntary dissolutions are not counted as impairments.

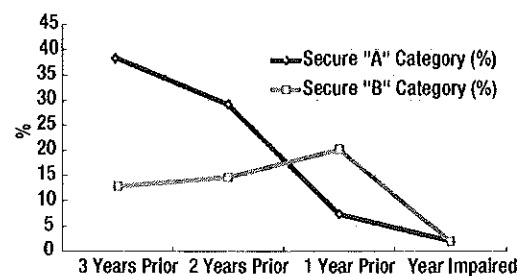
Exhibit 28 U.S. Surplus Lines – FICs by Line of Business (1977-2012)



Source: A.M. Best data & research

Exhibit 29 U.S. Surplus Lines FICs—Secure Best's Credit Ratings

For three years preceding impairment.



Note: "Secure "A" category includes A++, A+, A, A-, and FPR 7, 8 & 9 ratings. Secure "B" category includes B++, B+, and FPR 5 & 6 ratings.

Source: A.M. Best data & research

Revisions

As a result of ongoing research efforts, A.M. Best's impairment database is updated continually to reflect the incorporation of new data or adjustments to existing data. The most common revision to the data is a company's initial year of impairment. If any change places a company outside of this study's parameters, the company is eliminated from the study.

Confidential Supervisions

In addition to the regulatory actions that are announced publicly, there also are actions that insurance regulators undertake on a confidential basis. When A.M. Best becomes aware of an active confidential regulatory action, the impairment is counted in the aggregate analysis but is not reported on a company-specific basis to protect confidentiality. While the reporting of confidential actions likely is understated, A.M. Best believes a full accounting of these nonpublic actions would not change materially its impairment analysis.

Section VI – Fundamentals Of the Surplus Lines Market

The U.S. surplus lines market (also called the nonadmitted market) functions as a supplemental market for risks that are not acceptable to the standard insurance market (also called the admitted market).

The insurers in the surplus lines market are property/casualty companies that distribute products to consumers largely through surplus lines producers. Consumers that are unable to secure insurance coverage from standard (admitted) insurers also have the option of self-insuring or seeking coverage in the alternative risk transfer (ART) market. The risks placed in the surplus lines market usually can be classified as one of the following:

- **Distressed risks** – characterized by unfavorable attributes, such as a history of frequent losses that have made them unacceptable to admitted insurers.
- **Unique risks** – so specialized or unusual that admitted insurers are unwilling or unprepared to insure them.
- **High-capacity risks** – requiring high insurance limits that may exceed the capacity of the standard market.
- **New or emerging risks** – requiring special underwriting expertise and flexibility that the surplus lines market can provide.

Examples of coverages written by surplus lines carriers include: property catastrophe; cyber risk; excess and umbrella liability; high-hazard products liability; directors and officers liability; errors and omissions liability; special events liability; environmental impairment liability; and employment practices liability. The majority of surplus lines business is commercial lines, although some personal lines coverage is written on a nonadmitted basis, such as homeowners insurance in catastrophe-prone areas.

Surplus lines insurers are referred to as nonadmitted insurers because they are not licensed (admitted) in the state where the insured or risk is located. However, all U.S. jurisdictions have surplus lines laws that permit specially licensed intermediaries (surplus lines licensees) to “export” risks that cannot be placed in the standard market to eligible surplus lines insurers.

Each surplus lines insurer is licensed in its state or country of domicile and is regulated for solvency by that jurisdiction. State regulation of a licensed or admitted insurer includes the oversight of insurance rates and forms. The purpose of this regulatory activity is to ensure adequacy and fairness in pricing and coverage. The surplus lines market continues to provide an open, flexible market for insureds of all sizes. As a non-admitted carrier, a surplus lines insurer is not subject to the rate and form regulations of the insured’s home state and therefore is free to use policy forms and rates that are appropriate for the risks it accepts.

When the insurance market or capacity becomes restricted and market conditions “harden,” standard market carriers typically reduce their appetites for some risks or lines of insurance, and business flows into the surplus lines market. Even under normal market conditions or when the market is considered “soft,” there are still many distressed, unique, high-capacity and new or emerging risks that require surplus lines treatment. In fulfilling this role of insuring risks that the admitted market cannot or will

not insure, the surplus lines market is seen as performing a safety valve function for the insurance marketplace.

The minimum surplus requirements for surplus lines insurers are generally higher than for admitted insurers to provide greater protection for policyholders insured by surplus lines companies. This higher financial standard is deemed necessary because state guaranty fund protection, provided for policyholders of admitted insurers that become insolvent, is not generally available to surplus lines policyholders (see **Section II** for current financial trends in the surplus lines market).

Market Cycles

In general, the condition of the admitted insurance market affects the state of the surplus lines market (see **Section I** for the latest surplus lines market trends). This impact, on occasion, can be significant. When admitted market conditions harden or become more difficult, a sizable amount of business flows from the admitted market to the surplus lines market. During a hard market, underwriters tend to become more conservative and restrictive, examining loss exposures more carefully to determine how a particular risk under consideration can be written at a profit.

In these circumstances, standard market carriers write only the business they feel most comfortable underwriting and tend to avoid exposures and risks that are more complex or with which they are not particularly experienced.

As the market cycle progresses, competition heats up and market conditions in the admitted market "soften" as producers and insurers strive to maintain market share by reducing rates, expanding coverage and offering additional services at the expense of profit margins. During this soft market phase of the cycle, consumers' bargaining power increases significantly, causing rates to drop and coverage limitations or exclusions to be relaxed. When these conditions occur, business begins to return to the admitted market.

Over time, competitive pricing pressures erode admitted market capacity as margins deteriorate to unprofitable levels. This again leads to a hardening of the market, and the cycle continues.

Industry Participants

For the purposes of this report, A.M. Best has categorized surplus lines insurers into three broad segments.

- **Domestic professional companies:** This largest segment is represented by U.S.-domiciled insurers that write 50% or more of their total premiums on a nonadmitted basis.
- **Domestic specialty companies:** U.S.-domiciled insurers that operate to some extent on a nonadmitted basis but whose direct nonadmitted premium writings amount to less than 50% of their total direct premiums written.
- **Regulated aliens (including Lloyd's):** To qualify as a regulated alien, insurers must file financial statements, copies of auditors' reports, the names of their U.S. attorneys or other representatives, and details of their U.S. trust accounts with the International Insurers Department (IID) of the National Association of Insurance Commissioners (NAIC). Additionally, regulated aliens must fulfill criteria established by the IID concerning capital and/or surplus, reputation of financial integrity, and underwriting and claims practices. On a quarterly basis, the NAIC publishes its Quarterly Listing of Alien Insurers, which lists alien insurers that meet its criteria.

As a result of the Nonadmitted and Reinsurance Reform Act (NRRA) of 2010, which was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, a state may not prohibit a surplus lines broker from placing nonadmitted (surplus lines) insurance with or procuring such insurance from a nonadmitted insurer listed on the NAIC Quarterly Listing of Alien Insurers.

Specialty admitted companies obtain the majority of their business from wholesalers (including wholesale brokers, managing general agents and Lloyd's contract holders). These same intermediaries produce business for surplus lines insurers. Generally, wholesalers have greater expertise than do retailers in identifying and placing distressed, unique, high-capacity and new or emerging risks.

Wholesalers typically offer specialty admitted companies the first opportunity to consider a difficult-to-place risk. If unacceptable to the specialty admitted insurers, the risk is submitted to the surplus lines market.

Distribution

Retail producers, surplus lines intermediaries and program managers are the primary distributors for surplus lines insurers. All of these entities play an important role in helping consumers find insurance coverage that is unavailable in the standard market (see **Section IV** for a description of current surplus lines distribution issues).

For purposes of this special report, the types of organizations within the surplus lines distribution system are defined as follows:

- **Retail producers** can be either agents that represent the insurer or brokers that represent the insured.
- **Surplus lines intermediaries** can operate as wholesale brokers, managing general agents (MGAs), underwriting managers or Lloyd's correspondents through Lloyd's brokers.
- **Program managers** are managers of specialty or niche insurance products and market to retailers, wholesalers or both.

Surplus lines intermediaries are licensed in the states where the insured or risk is located and act as intermediaries between retail producers and surplus lines insurers. Typically, a surplus lines intermediary provides the retail producer and the insured with access to the surplus lines market when the admitted market cannot provide coverage or the risk otherwise qualifies for export.

The basic difference between wholesale brokers and MGAs is that MGAs are authorized to underwrite on behalf of the surplus lines insurer through binding authority agreements. Wholesale brokers only have the authority to submit business to surplus lines insurers. The insurers then underwrite, quote and, if the risk is considered to be acceptable, bind the risk. In addition, some MGAs have claims-handling responsibilities and may be involved in the placement of reinsurance.

Surplus lines laws generally require a "diligent search" before a risk can be exported to a surplus lines insurer. In general, the diligent-search requirement, which assures the admitted market the first opportunity to insure the risk, requires three declinations from admitted insurers before the risk can be placed in the surplus lines market.

In certain states, specified types of risks can be placed in the surplus lines mar-

ket without a diligent search for an admitted insurer. Many states have created an "export list," which lists types of risks for which the insurance commissioner has determined there is little or no coverage available in the admitted market. A type of risk that appears on the export list can be exported, without a diligent search, to an eligible, nonadmitted surplus lines insurer. Also, a few states have commercial lines deregulation laws that allow for "automatic export" waivers, giving qualifying commercial buyers and their brokers or intermediaries immediate access to the surplus lines market, as well as access to a deregulated admitted market, without a diligent search.

The surplus lines intermediary is responsible for:

- Filing an affidavit affirming that a diligent search has been performed, when required;
- Maintaining the records relating to the transaction; and
- Collecting premium taxes and remitting them to the state.

In addition to facilitating the surplus lines transaction, the surplus lines intermediary provides a number of services, including:

- Technical expertise about the risk to be insured;
- Extensive insurance product and market knowledge;
- Ability to respond quickly to changing market conditions; and
- Access to surplus lines insurers.

Licensing and Compliance

In a surplus lines transaction, the greatest portion of regulatory oversight occurs in the state where the insured's principal place of business is located and focuses on the surplus lines intermediary, also referred to as a surplus lines licensee, as the regulated entity in the transaction.

In addition to being a licensed (resident or nonresident) agent or broker, a surplus lines licensee must do the following:

- In many states, pass a written surplus lines licensing examination to secure a resident license;
- Collect the state's surplus lines premium taxes;
- Pay an annual licensing fee; and
- Determine whether the risk meets all the requirements for placement with a surplus lines insurer.

Further, the surplus lines licensee determines whether the insurer meets the insured's home state eligibility requirements. A licensee may be held liable for payment of claims when a risk is placed with a surplus lines insurer not authorized to receive the risk, or with one that is financially unsound when the risk is bound. However, depending on state law, there may be no cause of action against a broker, under a negligence standard, who exercises due diligence in selecting the insurer, even if the insurer becomes insolvent years later.

Surplus lines policies must disclose that a nonadmitted insurer is providing coverage and that guaranty fund protection will not be available if the insurer becomes insolvent.

Appendix A
U.S. Surplus Lines – Top 50 Groups (2012)
(\$ Thousands)

Rank	Group Name/Company Name	Type of Company	Surplus Lines DPW	Total Group PHS	Current Best's Rating
1	Lloyd's		\$6,270,000	\$31,204,626	A
2	American International Group		\$5,041,769	\$29,187,787	
	Chartis Specialty Insurance Co	PROF	\$810,363		A p
	Illinois National Insurance Co	MISC	\$14		A r
	Lexington Insurance Co	PROF	\$4,231,392		A p
3	Nationwide Group		\$1,441,724	\$13,795,822	
	Freedom Specialty Insurance Co	MISC	\$181		A+ r
	Nationwide Mutual Ins Co	MISC	\$9,637		A+ p
	Scottsdale Indemnity Co	MISC	\$18,565		A+ r
	Scottsdale Insurance Co	PROF	\$1,270,469		A+ p
	Scottsdale Surplus Lines Ins	PROF	\$10,754		A+ r
	Western Heritage Insurance Co	PROF	\$132,119		A+ r
4	Zurich Financial Svcs NA Group		\$1,176,246	\$7,677,594	
	Empire Fire & Marine Ins Co	MISC	\$84		A+ g
	Empire Indemnity Ins Co	PROF	\$145,033		A+ g
	Steadfast Insurance Co	PROF	\$1,025,078		A+ g
	Zurich American Ins Co of IL	MISC	\$6,050		A+ g
5	W. R. Berkley Insurance Group		\$1,116,108	\$4,671,980	
	Admiral Insurance Co	PROF	\$311,669		A+ r
	American Mining Insurance Co	MISC	\$5		A+ r
	Berkley Assurance Co	PROF	\$17,385		A+ r
	Berkley Regional Specialty Ins	PROF	\$16,850		A+ r
	Gemini Insurance Co	PROF	\$280,144		A+ r
	Great Divide Insurance Co	MISC	\$3,023		A+ r
	Nautilus Insurance Co	PROF	\$487,032		A+ r
6	QBE Americas Group		\$1,020,691	\$2,298,471	
	QBE Specialty Insurance Co	PROF	\$1,020,691		A p
7	ACE INA Group		\$874,590	\$5,666,743	
	Illinois Union Insurance Co	PROF	\$422,328		A+ g
	Westchester Surplus Lines Ins	PROF	\$452,262		A+ g
8	Markel Corporation Group		\$821,568	\$1,489,001	
	Associated International Ins	PROF	\$40,689		A g
	Essex Insurance Co	PROF	\$371,637		A g
	Evanston Insurance Co	PROF	\$409,242		A g
9	CNA Insurance Companies		\$740,808	\$9,998,354	
	Columbia Casualty Co	PROF	\$740,808		A g
10	Ironshore Insurance Group		\$674,192	\$388,804	
	Ironshore Indemnity Inc.	MISC	\$8,600		A g
	Ironshore Specialty Ins Co	PROF	\$665,592		A g
11	Alleghany Ins Holdings Group		\$647,079	\$5,784,275	
	Capitol Specialty Ins Corp	PROF	\$45,412		A g
	Covington Specialty Ins Co	PROF	\$12,103		A r
	Landmark American Ins Co	PROF	\$589,564		A r
12	Fairfax Financial (USA) Group		\$642,264	\$5,187,106	
	Crum & Forster Specialty Ins	PROF	\$56,333		A r
	First Mercury Insurance Co	PROF	\$367,682		A r
	Hudson Specialty Ins Co	PROF	\$147,194		A g
	Seneca Specialty Ins Co	PROF	\$71,050		A r
	Vallant Specialty Insurance Co	PROF	\$4		A r
13	AXIS Insurance Group		\$476,044	\$1,295,679	
	AXIS Surplus Insurance Co	PROF	\$476,044		A g
14	XL America Group		\$454,892	\$2,237,834	
	Indian Harbor Insurance Co	PROF	\$454,126		A g
	XL Select Insurance Co	PROF	\$766		A g
15	Arch Insurance Group		\$448,167	\$822,615	
	Arch Specialty Insurance Co	PROF	\$448,167		A+
16	Allied World Assurance Group		\$427,155	\$1,110,518	
	Allied World Asr Co (US) Inc	PROF	\$154,745		A g
	Allied World National Assur Co	MISC	\$49,015		A g
	Darwin National Assurance Co	MISC	\$632		A g

Appendix A

U.S. Surplus Lines – Top 50 Groups (2012)

(\$ Thousands)

Rank	Group Name/Company Name	Type of Company	Surplus Lines DPW	Total Group PHS	Current Best's Rating
	Darwin Select Insurance Co	PROF	\$222,764		A g
17	Chubb Group of Insurance Cos		\$426,451	\$13,841,016	
	Chubb Custom Insurance Co	PROF	\$361,809		A++ g
	Executive Risk Indemnity Inc	MISC	\$1,282		A++ g
	Executive Risk Specialty Ins	PROF	\$63,359		A++ g
18	Argo Group		\$409,909	\$779,070	
	Colony Insurance Co	PROF	\$404,675		A g
	Colony National Insurance Co	PROF	\$775		A g
	Colony Specialty Insurance Co	MISC	\$4,459		A g
19	Berkshire Hathaway Ins Group		\$408,693	\$106,670,703	
	Brookwood Insurance Co	MISC	-\$6		A++ r
	General Star Indemnity Co	PROF	\$125,651		A++ g
	General Star National Ins Co	MISC	\$2,257		A++ g
	Mount Vernon Fire Ins Co	PROF	\$104,265		A++ g
	National Fire & Marine Ins Co	PROF	\$127,745		A++ g
	National Indem Co of the South	MISC	\$4,724		A++ g
	U S Underwriters Insurance Co	PROF	\$33,486		A++ g
	United States Liability Ins Co	MISC	\$10,571		A++
20	Liberty Mutual Insurance Cos		\$355,104	\$16,770,678	
	Liberty Surplus Ins Corp	PROF	\$355,104		A p
21	HCC Insurance Group		\$336,382	\$1,978,551	
	Houston Casualty Co	PROF	\$320,593		A+ g
	HCC Specialty Ins Co	PROF	\$15,789		A+ r
22	Assurant P&C Group		\$319,307	\$1,391,489	
	Standard Guaranty Ins Co	PROF	\$131,850		A g
	Voyager Indemnity Ins Co	PROF	\$187,457		A g
23	Great American P&C Ins Group		\$314,537	\$2,145,828	
	American Emplr Surplus Lines	PROF	\$88,654		A+ p
	Great Amer Protection Ins Co	PROF	\$64		A r
	Great American E&S Ins Co	PROF	\$222,968		A r
	Great American Fidelity Ins Co	PROF	\$1,794		A r
	Mld-Continent Excess & Surplus	PROF	\$1,057		A+ r
24	Catlin US Pool		\$305,896	\$189,355	
	Catlin Specialty Insurance Co	PROF	\$305,896		A g
25	Munich-American Hldng Corp Cos		\$303,142	\$5,922,530	
	Amer Modern Surpl Lines Ins Co	PROF	\$35,099		A+ g
	American Modern Select Ins Co	MISC	\$1,027		A+ g
	American Western Home Ins Co	PROF	\$36,768		A+ g
	Princeton Excess & Surp Lines	PROF	\$230,248		A+ g
26	Travelers Group		\$285,134	\$19,327,224	
	Discover Specialty Ins Co	PROF	\$262		A+ g
	Gulf Underwriters Ins Co	PROF	\$23		A+ r
	Northfield Insurance Co	PROF	\$112,725		A+ g
	Northland Casualty Co	MISC	\$1,549		A+ g
	Northland Insurance Co	MISC	\$3,673		A+ g
	St. Paul Fire & Casualty Ins	PROF	\$97		A+ r
	St. Paul Surplus Lines Ins Co	PROF	\$43,610		A+ g
	Travelers Excess & Surp Lines	PROF	\$123,196		A+ g
27	Swiss Reinsurance Group		\$256,936	\$6,795,461	
	First Specialty Ins Corp	PROF	\$164,585		A+ g
	North American Capacity Ins Co	PROF	\$92,351		A+ g
28	Aspen US Insurance Group		\$250,063	\$273,196	
	Aspen Specialty Insurance Co	PROF	\$250,063		A g
29	Alterra Capital U.S. Group		\$244,719	\$671,627	
	Alterra Excess & Surplus Ins	PROF	\$244,719		A g
30	Starr International Group		\$244,705	\$1,947,884	
	Starr Surplus Lines Ins Co	PROF	\$244,705		A g
31	Endurance Specialty Group		\$243,484	\$612,127	
	Endurance American Spec Ins Co	PROF	\$243,464		A g
32	RLI Group		\$238,820	\$684,072	

Appendix A
U.S. Surplus Lines – Top 50 Groups (2012)
(\$ Thousands)

Rank	Group Name/Company Name	Type of Company	Surplus Lines DPW	Total Group PHS	Current Best's Rating
33	Mt Hawley Insurance Co	PROF	\$238,820	\$426,257	A+ g
	Meadowbrook Insurance Group		\$233,785		
	Century Surety Co	PROF	\$211,922		B++ p
	ProCentury Insurance Co	MISC	\$1,260		B++ p
34	Savers Property & Cas Ins Co	PROF	\$20,602	\$354,721	B++ p
	IFG Companies		\$229,216		
	Burlington Insurance Co	PROF	\$199,786		A g
	First Financial Insurance Co	PROF	\$27,140		A
35	Gulford Insurance Co	PROF	\$2,290	\$3,579,430	A g
	Allianz of America Companies		\$212,923		
	Allianz Global Risks US Ins Co	MISC	\$109		A+ g
	Allianz Underwriters Ins Co	PROF	\$5,962		A+ g
36	Fireman's Fund Ins Co of HI	MISC	\$26		A r
	Fireman's Fund Ins Co of OH	PROF	\$17,225		A r
	Interstate Fire & Casualty Co	PROF	\$189,602		A r
	Navicators Insurance Group		\$207,599		
37	Navicators Insurance Co	MISC	\$13	\$682,881	A
	Navicators Specialty Ins Co	PROF	\$207,586		A r
	Western World Insurance Group		\$205,501		
	Tudor Insurance Co	PROF	\$47,451		A+ p
38	Western World Insurance Co	PROF	\$158,050	\$1,511,870	A+ p
	White Mountains Insurance Grp		\$205,237		
	Homeland Ins Co of NY	PROF	\$194,773		A r
	Traders & General Ins Co	PROF	\$10,464		A u
39	American Safety Ins U.S. Grp		\$180,934	\$103,793	
	American Safety Indemnity Co	PROF	\$180,934		A u g
	Everest Re U.S. Group		\$180,220		
	Everest Indemnity Insurance Co	PROF	\$159,803		A+ g
40	Everest Security Insurance Co	MISC	\$416	\$2,633,414	A+ g
	Franklin Holdings Group		\$158,654		
	James River Casualty Co	PROF	\$2,423		A- g
	James River Insurance Co	PROF	\$156,231		A- g
41	State Auto Insurance Companies		\$138,867	\$1,009,469	
	Rockhill Insurance Co	PROF	\$138,867		A r
	Global Indemnity Group		\$137,625		
	Penn-America Insurance Co	PROF	\$48,425		A g
42	Penn-Patriot Insurance Co	PROF	\$2,048	\$411,940	A g
	Penn-Star Insurance Co	PROF	\$34,153		A g
	United National Insurance Co	PROF	\$51,684		A g
	United National Specialty Ins	MISC	\$1,314		A g
43	GeoVera U.S. Insurance Group		\$136,535	\$94,136	
	GeoVera Specialty Insurance Co	PROF	\$136,535		A g
	Torus Specialty Insurance Grp		\$133,042		
	Torus Specialty Insurance Co	PROF	\$133,042		A- g
44	Maxum Specialty Insurance Grp		\$126,384	\$96,704	
	Maxum Indemnity Co	PROF	\$126,384		A- p
	Companion Prop & Cas Group		\$121,321		
	Companion Specialty Ins Co	PROF	\$121,321		A r
45	Cincinnati Insurance Companies		\$111,413	\$3,913,598	
	Cincinnati Specialty Undrs Ins	PROF	\$111,413		A
	IAT Insurance Group		\$111,137		
	Acceptance Casualty Ins Co	PROF	\$5,410		A- g
46	Acceptance Indemnity Ins Co	PROF	\$69,767		A- g
	Wilshire Insurance Co	PROF	\$35,960		A- g
	Selective Insurance Group		\$98,393		
	Mesa Underwriters Spec Ins Co	PROF	\$98,393		A p
47	Malden Group		\$98,214	\$267,863	
	Malden Specialty Insurance Co	PROF	\$98,214		A- g

Source: A.M. Best data & research

Appendix B

U.S. Domestic Professional Surplus Lines – Entrances & Exits (2007-2012)

X denotes domestic professional surplus companies, defined as companies with direct premium from surplus lines business greater than 50% of total premium.

Company Name	2008	2009	2010	2011	2012	Company Name	2008	2009	2010	2011	2012
Acceptance Casualty Insurance Co					X	Executive Risk Specialty Insurance	X	X	X	X	X
Acceptance Indemnity Insurance Co	X	X	X	X	X	Fireman's Fund Ins Co of OH	X	X	X	X	X
Admiral Insurance Co	X	X	X	X	X	First Financial Insurance Co	X	X	X	X	X
Adriatic Insurance Co	X	X	X	X	X	First Mercury Insurance Co	X	X	X	X	X
AIG Excess Liability Insurance Co	X					First Specialty Insurance Corp	X	X	X	X	X
AIX Specialty Insurance Co	X	X	X	X	X	Gemini Insurance Co	X	X	X	X	X
Allianz Underwriters Insurance Co	X	X	X	X	X	General Security Indem Co AZ	X	X	X	X	X
Allied World Asr Co (US) Inc	X	X			X	General Star Indemnity Co	X	X	X	X	X
Alterra Excess & Surplus Ins		X	X	X	X	Genesis Indemnity Insurance Co	X	X	X		
American Empire Surplus Lines	X	X	X		X	GeoVera Specialty Insurance Co	X	X	X	X	X
American Intl Specialty Lines	X					GNV Custom Insurance Co		X	X	X	X
American Modern Surpl Lines Ins Co	X	X	X	X	X	Gotham Insurance Co	X	X	X	X	X
American Mutual Share Ins Corp	X	X	X	X	X	Great Amer Protection Insurance Co					X
American Safety Indemnity Co	X	X	X	X	X	Great American E&S Insurance Co	X	X	X	X	X
American Safety Insurance Co	X	X	X	X	X	Great American Fidelity Insurance Co	X	X	X	X	X
American Western Home Ins Co	X	X	X	X	X	Guilford Insurance Co	X	X	X	X	X
Appalachian Insurance Co	X	X	X	X	X	Gulf Underwriters Insurance Co	X	X	X		X
Arch Excess & Surplus Co	X	X	X	X		Halmark Specialty Insurance Co	X	X	X	X	X
Arch Specialty Insurance Co	X	X	X	X	X	HCC Specialty Insurance Co	X	X	X	X	X
Aspen Specialty Insurance Co	X	X	X	X	X	Hermitage Insurance Co					X
Associated Industries Insurance Co					X	Homeland Insurance Co of NY	X	X	X	X	X
Associated International Ins	X	X	X	X	X	Houston Casualty Co	X	X	X	X	X
Atain Insurance Co	X	X	X	X	X	Houston Specialty Insurance Co	X	X	X	X	X
Atain Specialty Insurance Co.	X	X	X	X	X	Hudson Specialty Insurance Co	X	X	X	X	X
Atlantic Casualty Insurance Co	X	X	X	X	X	Illinois Union Insurance Co	X	X	X	X	X
AXIS Specialty Insurance Co	X		X			Indian Harbor Insurance Co	X	X	X	X	X
AXIS Surplus Insurance Co	X	X	X	X	X	Integon Specialty	X				
Berkley Assurance Co				X	X	Interstate Fire & Casualty Co	X	X	X	X	X
Berkley Regional Specialty Ins	X	X	X	X	X	Ironshore Specialty Insurance Co	X	X	X	X	X
Burlington Insurance Co	X	X	X	X	X	James River Casualty Co		X	X	X	X
Canal Indemnity Co	X	X	X	X	X	James River Insurance Co	X	X	X	X	X
Canopus US Insurance, Inc.					X	Kinsale Insurance Co			X	X	X
Capitol Specialty Insurance Corp	X	X	X	X	X	Landmark American Ins Co	X	X	X	X	X
Catlin Specialty Insurance Co	X	X	X	X	X	Landmark Insurance Co	X	X	X	X	
Century Surety Co	X	X	X	X	X	Lexington Insurance Co	X	X	X	X	X
Chartis Select Insurance Co		X	X	X		Liberty Surplus Ins Corp	X	X	X	X	X
Chartis Specialty Insurance Co		X	X	X	X	Maiden Specialty Insurance Co		X	X	X	X
Chubb Custom Insurance Co	X	X	X	X	X	Max Specialty Insurance Co	X				
CIM Insurance Corporation			X	X	X	Maxum Indemnity Co	X	X	X	X	X
Cincinnati Specialty Undrs Ins	X	X	X	X	X	MOOW Insurance Co	X				
Clarendon America Insurance Co	X	X	X	X		Merchants National Ins Co		X	X	X	X
Colony Insurance Co	X	X	X	X	X	Mesa Underwriters Spec Ins Co					X
Colony National Insurance Co	X	X	X	X	X	Mid-Continent Excess & Surplus					X
Columbia Casualty Co	X	X	X	X	X	Montpellier US Insurance Co	X	X	X		
Companion Specialty Ins Co		X	X	X	X	MSA Insurance Co	X	X	X	X	X
Covington Specialty Ins Co	X	X	X	X	X	MSI Preferred Insurance Co		X	X	X	X
Crum & Forster Specialty Ins	X	X	X	X	X	Mt Hawley Insurance Co	X	X	X	X	X
CUMIS Specialty Ins Co Inc		X	X	X	X	Mt Vernon Fire Insurance Co	X	X	X	X	X
Darwin Select Insurance Co	X	X	X	X	X	NAMIC Insurance Co, Inc	X	X	X	X	X
Discover Specialty Insurance Co	X	X	X	X	X	National Fire & Marine Ins Co	X	X	X	X	X
Empire Indemnity Insurance Co	X	X	X	X	X	National Guaranty Ins Co of Vermont	X	X	X	X	X
Endurance American Spec Ins Co	X	X	X	X	X	Nautilus Insurance Co	X	X	X	X	X
Essex Insurance Co	X	X	X	X	X	Navigators Specialty Ins Co	X	X	X	X	X
Evanston Insurance Co	X	X	X	X	X	Newport Insurance Co					X
Everest Indemnity Insurance Co	X	X	X	X	X	Noetic Specialty Insurance Co	X	X	X	X	

Appendix B

U.S. Domestic Professional Surplus Lines – Entrances & Exits (2007-2012)

X denotes domestic professional surplus companies, defined as companies with direct premium from surplus lines business greater than 50% of total premium.

Company Name	2008	2009	2010	2011	2012	Company Name	2008	2009	2010	2011	2012
North American Capacity Ins Co	X	X	X	X	X	Specialty Surplus Insurance Co			X		
North Light Specialty Insurance Co	X	X	X	X	X	St. Paul Fire & Casualty Ins	X	X	X	X	X
Nutmeg Insurance Co	X	X	X	X		St. Paul Surplus Lines Ins Co	X	X	X	X	X
Old Guard Insurance Co			X	X	X	Standard Guaranty Ins Co	X	X	X	X	X
Old Republic Union Ins Co	X	X	X	X	X	Starr Surplus Lines Ins Co			X	X	X
Omega US Insurance Inc	X	X	X	X		Steadfast Insurance Co	X	X	X	X	X
Pacific Insurance Co, Ltd	X	X	X	X	X	TM Specialty Insurance Co	X	X	X	X	X
Penn-America Insurance Co	X	X	X	X	X	Tokio Marine Specialty Ins Co					X
Penn-Patriot Insurance Co	X	X	X	X	X	Torus Specialty Insurance Co		X	X	X	X
Penn-Star Insurance Co	X	X	X	X	X	Traders & General Ins Co		X	X	X	X
Philadelphia Insurance Co	X	X	X	X		Travelers Excess & Surp Lines	X	X	X	X	X
Prime Insurance Co	X	X	X	X	X	TrustStar Insurance Co					X
Prime Insurance Syndicate Inc	X					Tudor Insurance Co	X	X	X	X	X
Princeton Excess & Surp Lines	X	X	X	X	X	United National Insurance Co	X	X	X	X	X
ProAssurance Specialty Ins Co	X	X	X	X	X	United Specialty Insurance Co	X	X	X	X	X
Professional Security Ins Co		X	X			US Underwriters Insurance Co	X	X	X	X	X
Professional Underwriters Liability	X	X	X	X	X	Utica Specialty Risk Ins Co	X	X	X	X	X
Protective Specialty Ins Co				X	X	Vallant Specialty Insurance Co		X	X	X	X
QBE Specialty Insurance Co	X	X	X	X	X	Voyager Indemnity Ins Co	X	X	X	X	X
Rainier Insurance Co	X					Westchester Surplus Lines Ins	X	X	X	X	X
Republic-Vanguard Ins Co	X	X	X	X	X	Western Heritage Insurance Co	X	X	X	X	X
Rockhill Insurance Co	X	X	X	X	X	Western World Insurance Co	X	X	X	X	X
SAFECO Surplus Lines Insurance Co	X	X	X	X		Wilshire Insurance Co					X
Sagamore Insurance Co				X	X	XL Select Insurance Co	X	X	X	X	X
Savers Property & Casualty Ins Co	X				X	ZC Specialty Insurance Co	X				
Scottsdale Insurance Co	X	X	X	X	X						
Scottsdale Surplus Lines Ins		X	X	X	X						
Seneca Specialty Ins Co	X	X	X	X	X						
Southwest Marine & General	X	X	X	X	X						
SPARTA Specialty Insurance Co					X						

Source: A.M. Best research

Appendix C

U.S. State Survey: Regulated & Unregulated Alien Lists

State	Regulated Alien List Maintained	Unregulated Alien List Maintained	Alien Insolvencies Tracked	Fraud Unit	State	Regulated Alien List Maintained	Unregulated Alien List Maintained	Alien Insolvencies Tracked	Fraud Unit
Alabama	No	No	No	Yes	Montana	No	Yes	No	Yes
Alaska	Yes**	No	No	Yes	Nebraska	No	No	No	Yes
Arizona	No**	No	No	No	Nevada	Yes**	No	No	Yes
Arkansas	Yes**	No	No	Yes	New Hampshire	Yes**	No	No	No
California	Yes**	No	No	Yes	New Jersey	No*	No	No	No
Colorado	Yes	No	No	Yes	New Mexico	Yes*	No	No	No
Connecticut	No	No	No	Yes	New York	No	No	Yes	Yes
Delaware	Yes	No	No	No	North Carolina	Yes (6)	Yes	No	Yes
Dist of Columbia	No	No	No	No	North Dakota	Yes**	No	No	Yes
Florida	Yes (1)	Yes (2)	No (3)	Yes (4)	Ohio	Yes**	Yes	No	No
Georgia	Yes**	No	No	Yes	Oklahoma	Yes	No	No	No
Hawaii	Yes**	No	No	No	Oregon	No	No	No	No
Idaho	Yes*	No	Yes	Yes	Pennsylvania	No***	No	Yes	Yes
Illinois	No	Yes	No	Yes	Rhode Island	Yes**	No	No	No
Indiana	Yes*	No	No	No	South Carolina	Yes*	No	No	No
Iowa	Yes*	No	No	No	South Dakota	No	No	No	Yes
Kansas	Yes*	No	No	Yes	Tennessee	No	No	No	No
Kentucky	Yes*	No	No	Yes	Texas	Yes	No	Yes	Yes
Louisiana	Yes	No	No	Yes	Utah	Yes	No	Yes	Yes
Maine	Yes	No	No	No	Vermont	No	No	No	No
Maryland	Yes*	No	No	No	Virginia	No	No	No	No
Massachusetts	Yes**	No	No	Yes	Washington	No	No	No	Yes
Michigan (5)	Yes	No	No	No	West Virginia	Yes*	No	No	Yes
Minnesota	Yes	No	No	Yes	Wisconsin	No	No	No	No
Mississippi	Yes**	No	No (3)	Yes	Wyoming	Yes**	No	No	No
Missouri	Yes*	No	No	Yes					

* Uses the "white list" from the International Insurers Department of the National Association of Insurance Commissioners (NAIC).

** Uses the "Quarterly Listing of Alien Insurers" from the International Insurers Department of the NAIC to qualify aliens for the ADOI "List of Qualified Unauthorized Surplus Lines Insurers".

*** The Pennsylvania Insurance Department maintains a listing of all eligible surplus lines insurers including alien insurers.

(1) The Florida Office of Insurance Regulation maintains a current listing of all surplus lines insurers including aliens.

(2) The Florida Office of Insurance Regulation maintains a list of Federally Authorized Insurers that claim federal exemption (IID list).

(3) An alien insurer insolvency is not tracked once it has become insolvent or disappeared.

(4) There is a unit for unlicensed/unapproved entities that is operated out of the Market Conduct section of the Florida Office.

of Insurance Regulation. There is no routine monitoring of unregulated alien insurers.

(5) The Michigan Office of Financial and Insurance regulation maintains a current listing of all eligible unauthorized surplus lines including aliens.

(6) The North Carolina Department of Insurance maintains a current listing of all surplus lines carriers that have applied and been approved for registration, including aliens.

Source: A.M. Best research, as of Aug. 31, 2013.

Appendix D

U.S. State Survey: Capital & Surplus Requirements for Surplus Lines Companies

State	Domestic Company Minimum Surplus	Alien Company Minimum Surplus	Pending Revisions	State	Domestic Company Minimum Surplus	Alien Company Minimum Surplus	Pending Revisions
Alabama	\$5,000,000	\$2,500,000 (1)/ 15,000,000	No	Missouri	15,000,000	15,000,000	Yes
Alaska	15,000,000	15,000,000/ 2,500,000 (1)	No	Montana	15,000,000	15,000,000	Yes
Arizona	15,000,000	15,000,000 (8)/ 5,400,000 (1)	No	Nebraska	15,000,000	(9)	No
Arkansas	20,000,000	N/A	No	Nevada	15,000,000	5,400,000/ 100,000,000 (4)	Yes
California	45,000,000 (2)	(8)	No	New Hampshire	15,000,000	N/A	No
Colorado	15,000,000	5,400,000	No	New Jersey	15,000,000(6)	15,000,000(6)	No
Connecticut	15,000,000	15,000,000	No	New Mexico	15,000,000(5)	15,000,000(5)	N/A
Delaware	15,000,000	15,000,000	No	New York	45,000,000	45,000,000 (9)	No
Dist of Columbia	300,000	300,000	No	North Carolina	15,000,000	15,000,000	No
Florida	15,000,000	15,000,000 (3)	No	North Dakota	15,000,000	15,000,000	No
Georgia	4,500,000	10,000,000/ 10,000,000 (1)	No	Ohio	5,000,000	15,000,000	No
Hawaii	15,000,000	5,400,000 (1)	No	Oklahoma	15,000,000	15,000,000	No
Idaho	2,000,000	15,000,000	No	Oregon	5,000,000	15,000,000/ 5,400,000 (3)	No (6)
Illinois	15,000,000	15,000,000	No	Pennsylvania	15,000,000/ 4,500,000	(8) 4,500,000	No
Indiana	15,000,000	15,000,000	No	Rhode Island	15,000,000	15,000,000	No
Iowa	15,000,000	N/A		South Carolina	15,000,000	15,000,000	No
Kansas	4,500,000	50,000,000	No	South Dakota	500,000	500,000	No
Kentucky	6,000,000	5,400,000 (3)	No	Tennessee	15,000,000/ 15,000,000	Listed with NAIC International Insurers Depart- ment	No
Louisiana	15,000,000	15,000,000 (8)	No	Texas	15,000,000	(8)	No
Maine	4,500,000	Listed with NAIC International Insurers Depart- ment (9)	No	Utah	2,500,000 (1)	50,000,000/ 15,000,000	No
Maryland	15,000,000	N/A	No	Vermont	15,000,000	15,000,000	No
Massachusetts	20,000,000	20,000,000	Yes	Virginia	1,000,000/ 3,000,000	Deemed Approval (7)	No
Michigan	7,500,000	15,000,000	Yes (5)	Washington	15,000,000	(9)	No
Minnesota	15,000,000	15,000,000	No	West Virginia	15,000,000	15,000,000	No
Mississippi	1,500,000	15,000,000/ 5,400,000 (3)	No	Wisconsin	N/A	N/A	No
				Wyoming	15,000,000	15,000,000(9)	No

(1) Trust Fund

(2) Minimum surplus phase-in period for US- domiciled nonadmitted insurer currently on the California list of eligible surplus lines Insurers that did not meet the \$45 million minimum capital and surplus requirements as of Jan. 1, 2011: the insurer must have capital and surplus of 45 million by Dec. 31, 2013.

(3) In addition, alien carriers required to maintain \$5.4 million trust fund in the United States.

(4) Lloyd's

(5) Due to Dodd-Frank.

(6) This law took effect 1/1/2012.

(7) Insurers appearing on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC deemed approved in Virginia.

(8) Alien Company must be listed on the Quarterly Listing of Alien Insurers maintained by the International Insurance Department of the NAIC.

(9) Due to Dodd-Frank, NAIC Quarterly Listing of Alien Insurers is used for verification purposes. As of 1/1/2013 new alien insurers require \$45 million.

Source: A.M. Best research, as of Aug. 31, 2013.

Appendix E

U.S. State Survey: Stamping Office and Multistate Taxation of Surplus Lines Transactions

State	Stamping Office	Premium Tax	Stamping Fee	Tax Allocated	Procurement Tax Applies	Procurement Monitored
Alabama	No	6.00%	No	No	Yes	No
Alaska	No	2.70%	1.00%	No	Yes	Insured Reports
Arizona	Yes	3.00%	0.20%	No	No	No
Arkansas	No	4.00%	No	No	Yes	Yes
California	Yes	3.00%	0.20%	No	Yes (1)	Yes (1)
Colorado	No	3.00%	No	No	Yes	Yes
Connecticut	No	4.00%	No	No	Yes	Yes
Delaware	No	2.00%	No	No	Yes	Insured Reports
Dist of Columbia	No	2.00%	No	No	Yes	No
Florida	Yes	5.00%	0.20%	Yes(3)	Yes	Yes
Georgia	No	4.00%	No	No (8)	Yes	Insured Reports
Hawaii	No	4.68%	No	No	Yes	Insured Reports
Idaho	Yes	1.50%	0.25%	No	No	No
Illinois	Yes	3.50%	0.10%	No	No	No
Indiana	No	2.50%	No	No	Yes	Yes
Iowa	No	1.00%	No	No	Yes	No
Kansas	No	6.00%	No	No	No	No
Kentucky	No	3.00%	No	No	No	Yes
Louisiana	No	5.00%	No	Yes	Yes	Insured Reports
Maine	No	3.00%	No	No	Yes	Yes
Maryland	No	3.00%	No	N/A	Yes	Insured Reports
Massachusetts	No	4.00%	No	No	No	No
Michigan	No	2.00%*	No	No	No	Yes - Insured Reports
Minnesota	Yes	3.00%	0.08%	N/A	No	No
Mississippi	Yes	4.00%	0.25%	No	Yes	Yes
Missouri	No	5.00%	No	No	Yes	Yes
Montana**	No	2.75%	0.00%	No	No	No
Nebraska	No	3.00%	No	No	No	No
Nevada	Yes	3.50%	Eff. 1/1/07 0.40%	No	Yes	Yes
New Hampshire	No	3.00%	No	No(9)	Yes	Yes
New Jersey	No	5.00%	No	No*	Yes (1)	No
New Mexico	No	3.003%	N/A	N/A	No	No
New York	Yes	3.60%	0.20%	No (4)	Yes	Yes (2)
North Carolina	No	5.00%	No	No	Yes	Insured Reports
North Dakota	No	1.75%	No	No (5)	Yes	No
Ohio	No	5.00%	No	No	Yes	No
Oklahoma	No	6.00%	No	No	No	Insured Reports
Oregon	Yes	2.3% (6)	\$15.00	No	Yes	No
Pennsylvania	Yes	3.00%	\$25.00	No	Yes	Insured Reports
Rhode Island (9)	No	2.00%	No	No	No	No
South Carolina	No	4.00%	No	No	No	No
South Dakota	No	2.5% - 3.0%	No	Yes	Yes	Yes
Tennessee	No	5.00%	No	No	No	No
Texas	Yes	4.85%	0.06%	No	Yes	Insured Reports
Utah	Yes	4.25%	0.25%	Yes	Yes	No
Vermont	No	3.00%	No	N/A	Yes	Yes
Virginia	No	2.25%	No	No	No	No
Washington	Yes	2.00%	0.10%	No	Yes	Yes

Appendix E

U.S. State Survey: Stamping Office and Multistate Taxation of Surplus Lines Transactions

State	Stamping Office	Premium Tax	Stamping Fee	Tax Allocated	Procurement Tax Applies	Procurement Monitored
West Virginia	No	4.55%	No	No	No	No
Wisconsin	No	3.00%	No	No	Yes (7)	No
Wyoming	No	3.00%	No	Yes	Yes	Yes

* Plus 0.5% regulatory fee in Michigan.

** Effective 01/01/2012, Montana's stamping fee is 0.00% for electronically filed policies and endorsements, and paper filings have a 0.25% stamping fee.

(1) Not by DOI; handled by state franchise tax board.

(2) Not by DOI; handled by Department of Revenue Services/Taxation.

(3) Florida has joined the tax sharing agreement of NIMA. Since 7/1/2012, all Florida home state policies get filed at the NIMA Clearinghouse, and other NIMA participants will get their portion of the allocated premium. Nonparticipating states' premium will be retained by the home state.

(4) New York as of July 21, 2011 no tax allocation. Additionally, where NY is the "home state of the insured" and the policy covers risks located both inside and outside the United States, only the portion of the premium attributable to the risk inside the United States is subject to 100% tax.

(5) Tax payable is sum of 1.75% on portion of gross premiums allocated to North Dakota plus other states' applicable tax rates and fees applicable on portion of premiums allocated to other states. (NDCC 26.1-44-03.1)

(6) This amount includes 0.3% collected for Oregon Fire Marshall's office.

(7) Tax now 3% on ocean marine business.

(8) Effective 7/1/12, multi-state allocation does not apply. Pay 4% on entire premium when Georgia is the home state.

(9) Premium taxes are handled by the Division of Taxation.

Source: A.M. Best research, as of Aug. 31, 2013.

A.M. Best's 20th Special Report on the Surplus Lines Market

This is the 20th annual special report on the surplus lines market prepared by A.M. Best Company with a grant from the Derek Hughes/NAPSLO Educational Foundation. For the three years 1994, 1995 and 1996, the foundation provided a grant to A.M. Best to conduct a solvency study of the surplus lines market. These reports initially were commissioned to fill the void of information on the solvency record of surplus lines companies in an informed and objective manner.

Since 1997, these reports have been expanded to examine a variety of issues the surplus lines market faces, while continuing the annual review of solvency performance. These additional subjects have included market trends, potential federal regulation, commercial lines deregulation, stamping offices, Lloyd's, mergers and acquisitions, and the distribution system.

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